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Are Unilateral Domestic Measures Enough to Eliminate Economic Double Taxation Generated by CFC legislation?

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Statement of Integrity:

I hereby declare having conducted this academic work with integrity. I confirm that I have not used plagiarism or any form of undue use of information or falsification of results along the process leading to its elaboration.

I further declare that I have fully acknowledged the Code of Ethical Conduct of the University of Minho.

Abstract:

Double taxation of CFC legislation needs to be eliminated in order to strike a balance between tackling BEPS activities and preserving the attractiveness of the jurisdiction applying CFC legislation. Both the OECD BEPS project and the EU ATA directive contain recommendations for the elimination of double taxation situations of CFC legislation. However, the objective of this work is to see whether unilateral domestic rules, included in CFC legislation, are enough for eliminating situations of double taxation of CFC rules and whether such situations could benefit from tax treaty relief provisions. Hence this work explores CFC legislation, in the light of the OECD Action Plan 3 and the EU ATA directive. The work also seeks to see whether CFC rules are compatible with tax treaty law and whether a treaty benefit is available. In the end, we find that unilateral domestic measures may not be enough for a full elimination of all situations of double taxation of CFC rules. Still, they are the only possible solution in the absence of a treaty benefit. However, the conclusion is aimed at answering whether unilateral domestic measures are enough and what are the possible solutions for the elimination of double taxation situations of CFC rules.

Key-Words: CFC Rules, Anti-Tax Avoidance Rules, Anti-BEPS Measures, OECD Action Plan 3, EU ATA Directive, Double Taxation, Tax Treaty Benefits.

Resumo:

É necessário eliminar a dupla tributação das normas CFC (mecanismo de imputação de rendimentos de entidades não residentes sujeitas a um regime fiscal privilegiado) a fim de obter um equilíbrio entre as atividades do Plano BEPS e a preservação da atratividade das jurisdições que aplicam as normas CFC. Tanto o Plano BEPS da OCDE (Organização para a Cooperação e Desenvolvimento Económico) e a diretiva ATA da EU (Diretiva Antielisão Fiscal da UE) contêm recomendações para a eliminação de situações de dupla tributação das normas CFC. No entanto, o objetivo deste trabalho é verificar se as normas CFC nacionais unilaterais são suficientes para eliminar situações de dupla tributação das normas CFC e se tais situações podem beneficiar de desagradamento fiscal. Portanto, este trabalho estuda as normas CFC à luz do Plano de Ação 3 da OCDE e da Diretiva Antielisão Fiscal da UE. O trabalho também tem como objetivo verificar se as regras CFC são compatíveis com as convenções fiscais e se tais convenções atribuem algum desagradamento fiscal. No final, chegamos à conclusão de que os mecanismos nacionais unilaterais podem não ser suficientes para a eliminação total de todas as situações de dupla tributação das regras CFC. Contudo, estas normas são a única solução possível na ausência de as convenções não preverem um desagradmento fiscal. No entanto, a conclusão visa responder se os mecanismos nacionais unilaterais são suficientes e quais são as possíveis soluções para a eliminação de situações de dupla tributação das regras CFC.

Palavras-chave: Normas CFC; Regras Antielisão Fiscal; Medidas anti-BEPS; Plano de Acção 3 da OCDE; Diretiva Antielisão Fiscal da EU; Dupla Tributação; Desagradamento fiscal nas Convenções.

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Abbreviations:

BEPS	Base Erosion and Profit Shifting
CEN	Capital Export Neutrality
CFC	Controlled Foreign Corporation
CIN	Capital Import Neutrality
EU	European Union
EU ATAD	European Union Anti-Tax Avoidance Directive
FAPI	Foreign Accrual Passive Income
GAARs	General Anti-Avoidance Rules
ICIJ	International Consortium of Investigation Journalists
IFRS	International Financial Reporting Standards
MNEs	Multinational Enterprises
OECD	Organisation for Economic Co-operation and Development
OECD MC	Organisation for Economic Co-operation and Development Model Convention
PEs	Permanent Establishments
SAARs	Special Anti-Avoidance Rules

Chapter (i). Tax Avoidance and Mechanisms to Avoid It.

1. Introduction:

Recent leaks of multinational enterprises' practices such as the Panama's leaks and the Luxembourg leaks, have highlighted the high extent of companies' abusive tax practices. The issue of tax avoidance is not new and have been a subject of discussion for a long time. However, MNEs schemes took what is known as tax planning or accepted tax avoidance to another level way beyond the intention of the legislator. Several world-large MNEs appear to be paying too low, or no taxation. Such schemes by MNEs are generally based on complex arrangements set by companies to exploit loopholes in tax rules. Moreover, MNEs are taking advantage of the differences of tax rules in the world and are preforming international schemes to reduce their taxable income to the minimum possible. Such behaviour may be called aggressive tax planning, which although appears to be legal it is very harmful not only for jurisdiction but also for other taxpayers.

MNEs need a location with good infrastructure to perform their production or services activities. Therefore, they are supposed to pay their fair share of taxes as a contribution for the jurisdiction that offers the needed infrastructure. However, jurisdictions, on the other hand, need to enact rules that is clear and provide certainty for taxpayers. Hence, the OECD/G20 initiative started the Base Erosion and Profit Shifting BEPS project to develop rules aimed at tackling BEPS practices. Moreover, one of the essential anti-avoidance measures is controlled foreign corporation rules. CFC rules are designed to prevent MNEs from conducting BEPS activities. Therefore, Action plan 3 of the OECD BEPS project provides recommendations for the best practice of CFC legislation.

Although CFC legislation is very important for tackling abusive tax avoidance practices, it may have a negative impact on both the jurisdictions applying the legislation and companies located in these jurisdictions. The application of CFC legislation could raise the issue of double taxation, which could negatively impact international commerce. Jurisdictions, on the first hand, need to tackle tax avoidance practices. However, jurisdictions, on the other hand, want to keep the attractiveness of their regimes. Hence, double taxation situations of CFC legislation are usually avoided by domestic measures inclined in CFC legislations.

Therefore, the objective of this work is to see whether domestic measures of CFC legislation are enough for the prevention or the elimination of double taxation situations resulting by the application of CFC legislation and whether double taxation of CFC rules could benefit from tax treaty relief provisions.

However, to answer our question, the work is divided into four chapters. Chapter (i) is introducing tax avoidance and clearing the line between the concepts of tax evasion, tax avoidance and tax planning. In addition, General and specific anti-avoidance rules are also introduced. Chapter (ii), we are exploring CFC legislation, what is the rationale behind it and what are the features of the legislation, taking into considerations the recommendation of the OECD and the EU ATA directive. Chapter (iii) targets the issue of double taxation of CFC legislation and whether it could be eliminated by benefiting from tax treaty relief provisions. However, in order to reach such answer, we are exploring the compatibility of CFC legislation with tax treaties. Chapter (iv) we are concluding our work by answering the main research question and extending it to provide possible solutions.

1.1 Methodology:

This research is based on exploratory/formative research, where it aims to gain familiarity with the topic and to achieve new insights into the subject. It also consists of analytical research methods using all information and facts available, to be analysed and critically evaluated. Both comparative and descriptive approaches are used to investigate different issues and challenges. Several stages are followed throughout the research, starting from the collection of available data to the classification of each set of information into its structured chapter. The legal research of this work consults various available resources, such as library-based investigations, and consults relevant sources, like books and texts, in addition to jurisprudence and case law. Other methods of research are consulted such as online research using the available access to journal and legal search engines, e.g. Lexis-Nexis, Hein Online, IBFD Tax Research Platform and others.

Moreover, the topics of the research are addressed based on different levels, starting from the national to international level looking at international dimensions of the research area and also international institutions such as the OECD, also at the EU level looking at the new EU ATA directive and other relative information.

2. International tax avoidance:

Tax law, although it is a new field of law in comparison with other fields of law, is a very complex one indeed. Jurisdictions enact their tax regimes to organise both corporate and personal income taxation laying the structure of countries' legal tax systems. However, tax rules are not always entirely effective, and gaps may exist, which are usually referred to as legal loopholes. Multinational Enterprises (Starting Now 'MNEs') may exploit such loopholes to have tax benefits. Legal loopholes in tax law, in most cases, are a result of the difference in tax regimes of different countries. Each jurisdiction enacts domestic rules enabling tax authorities to subject individuals and companies to tax. Income is either taxed under personal income tax in the hand of individuals or taxed under corporate income tax in the hand of corporate entities. However, and under the fundamental separation principle[1], companies are treated as separated legal entities from their owners or shareholders, for tax law purposes. Therefore, corporate income is subject to tax at the level of the corporation disregarding its shareholders.

Moreover, tax rules are not harmonised internationally, and they are different from one jurisdiction to another. Jurisdictions are sovereign and they design their tax regime in the manner that serves their policy considerations. However, when designing tax rules, several aspects are taken into consideration regarding each of the social, economic and legal objectives of the country. Therefore, legal features of tax rules such as tax rates are different between countries. Such variations in tax rules offer sort of tax competition between jurisdictions where tax systems may be used to attract foreign investments. Hence, MNEs tend to make use of such competition aspects and subsidiaries may be established in other jurisdictions with a low tax, or no tax, rates. MNEs abusive practices may represent the flipside of harmful tax competition.[2]

The Organization for Economic Co-operation and Development OECD (Starting Now 'OECD'), (Introduced in Chapter III 2.1), had extensively dealt with the phenomenon of harmful tax competition in the late 90s,[3] and the first significant report on the issue was published in 1998 titled "*Harmful Tax Competition: An Emerging Global Issue*".[4] In this report and several other reports by the OECD, efforts to fight tax havens and preferential tax regimes were encouraged. Recommendations were given to strengthen the commitment to principles of transparency and exchange of information. The recommendations paved the way to a dialogue between OECD and non-OECD members to develop rules

[1] Murray A. Pickering, *The Company as A Separate Legal Entity*, Volume 31 No. 5 (Modern Law Review 1968) p. 481
[2] H. J. Ault, W. Schon and S. E. Shay, *Base Erosion and Profit Shifting: A Roadmap for Reform*, (68 Bull. Int'l Tax 2014) p. 275
[3] Christiana HJI Panayi, *Advanced Issues in International and European Tax Law*, (Hart Publishing 2015) p. 5
[4] OECD, *Harmful Tax Competition: An Emerging Global Issue*, (OECD Publications 1998)

tackling the use of tax havens and other preferential tax regimes. Although not all jurisdictions showed their support for the recommendations in the beginning, the issue was under a big debate after the 2008 economic crises. Tax havens and preferential tax regimes were accused of committing harmful tax competition and enabling aggressive tax planning.[5] Besides, governments and the public were aware of the harmful impact of tax havens practices after many scandals which were leaked indicating that some large MNEs are paying so little taxes or even no tax at all where the value of their profit is created.

Taxation can have an important effect on cross-border investment strategies and may contribute to the decision-making of MNEs investments. For MNEs international tax planning is a part of their corporate strategy, where they aim at reducing the tax burden to the least minimum possible. MNEs are free to arrange their businesses in the way they see appropriate and tax incentives may sometime be a priority. Avoiding higher tax burdens may be one of the corporate strategy drivers, however, some MNES may sometimes go beyond that and make tax planning their only driver. Hence, arrangements may be made for the sole purpose of avoiding tax burdens.

MNEs usually plan to reduce their worldwide tax burden by:

"*(i) seeking to minimise the taxable income in high-tax jurisdictions, (ii) preventing or delaying earnings and/or investment's income from entering high-tax jurisdictions by 'parking' them in a very low-tax countries until they are needed elsewhere within the group, (iii) siting operations (especially financial operations) in low-tax countries wherever possible to reduce the MNE's average tax rate on its worldwide profits.*".[6] By such arrangements, MNEs may either delay the repatriation of their profits to their high-tax home county or simply keep the profits outside its home country.

MNEs practices have recently brought the attention of the public highlighting their aggressive tax planning, which although legal they harm the taxable base of home countries and also other countries. In addition, the legality of some arrangements is being questioned to the extent of whether they fall under what is considered to be tax planning. Therefore, we are going to see what the concept of tax planning is and how it differs from tax avoidance and tax evasion.

[5] Christiana HJI Panayi, *Advanced Issues in International and European Tax Law*, (Hart Publishing 2015) p.6-7
[6] A. Miller and L. Oats, *Principles of International Taxation*, Fifth Edition (Bloomsbury Professional Ltd 2016) p. 544

2.1 Definition of Tax Evasion, Tax Avoidance and Tax Planning.

The dividing line between tax evasion and tax avoidance could be identified based on certain criteria, however the case is more complicated when it comes to the one between tax avoidance and tax planning. MNEs arrangements may vary between what is legal and what is not, also between what is acceptable and what is not. Although most jurisdictions and international organisations share similar or the same principles that define tax evasion, that Is not the case for tax avoidance. However, each of the terms needs to be defined to spot the difference between the concepts.

2.1.1 Tax Evasion:

In general, all tax evasion practices are illegal, and in most situations may be criminalised. The OECD defines tax evasion as "*The term 'tax evasion' is generally used to mean illegal arrangements where the liability to tax is hidden or ignored*"[7]. Tax evasion, therefore, contains an element of dishonesty, on the level of the taxpayer. Tax evasion happens when a taxpayer intentionally works to avoid tax liability or reduce the taxable base by illegal means. However, what is legal, or illegal is determined by domestic regulations of each jurisdiction. A widely adopted definition of tax evasion is when "*The taxpayer avoids the payment of tax without avoiding the tax liability, so that he escapes the payment of tax that is unquestionably due according to the law of the taxing jurisdiction and even breaks the letter of the law*" [8] The OECD also contributed to the definition of tax evasion in their 1987 report on *International Tax Avoidance and Evasion* where it was mentioned that "*the term covers an action by the taxpayer which entails breaking the law and which moreover can be shown to have been taken with the intention of escaping payment of tax*".[9]

Accordingly, tax evasion is the avoidance of existing tax liability by a taxpayer with the sole purpose of escaping tax payments. A simple example that could explain tax evasion is when an owner of a property receives payment on the rent of the property and provide false information or refrain from declaring the income that he has earned.[10]

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[7] OECD, *Glossary of tax terms,* available at <http://www.oecd.org/ctp/glossaryoftaxterms.htm> Accessed on 10 October 2018.
[8] Raffaele Russo, *Fundamental of International Tax planning,* (IBFD 2007) p. 50
[9] OECD, *International Tax Avoidance and Evasion – Four Related Studies,* (Paris 1987)
[10] This example has the intention to make a better understanding of tax evasion; however, in reality, there are more complicated situations of tax evasion.

2.1.2 Tax avoidance:

There has been a lot of discussion over what is tax avoidance and how it can be distinguished from tax evasion and tax planning. The issue, although might seem to be simple at the first instinct, is very complex. In tax evasion, the tax liability exists but taxpayers escape from fulfilling such liability. However, tax avoidance affects the existence of the tax liability itself. Therefore, although tax avoidance may seem legal in several occasions, its legality is questionable. The term tax avoidance is "*generally used to describe the arrangements of taxpayer's affairs that is intended to reduce his tax liability*".[11] Tax avoidance arrangements could be legal or, in other words, according to the letter of the law. Nevertheless, they might be against the spirit of law, because they contradict the intention of the tax rule. Tax avoidance abusive practices reduce obvious taxes in a manner not intended by law.[12]

In tax avoidance, taxpayers tend to arrange legal, financial transactions or schemes intending to reduce their tax liability. The 1987 OECD report on *International Tax Avoidance and Evasion* mentioned that governments should be concerned about the fiscal equity of financial arrangements of MNEs, that have severely affected international competition and capital flows. Therefore, governments are keen to develop their tax regimes to tackle such arrangements which are unacceptable to them.

A distinction of tax avoidance and tax evasion is when "One 'evades' taxes by avoiding the payment without avoiding liability, while one who avoids liability 'avoids' the tax".[13] This illustration brings the light to the legality of tax avoidance and how a taxpayer who actually avoids tax liability is in the safe harbour of the law, where on the other hand, the avoidance of the mere payment of tax might hold him liable. Moreover, to facilitate the determination of certain arrangements unaccepted tax avoidance and tax evasion may be construed under the umbrella of 'non-compliance'.[14]

The OECD report of 1987 had set some criteria which help to determine tax avoidance. The report provides three elements of tax avoidance: (i) almost invariably, there is a presence of an element of artificiality to it or, to put this in another way, the various arrangements in a scheme do not have business or economic aims as their primary purpose, (ii) secrecy may also be a feature of modern avoidance, and (iii) tax avoidance often takes advantage of loopholes in the law when applying legal provisions, for purposes which were not intended.[15] Thus, tax avoidance is determined by the lack of

[11] OECD, *Glossary of tax terms,* available at <http://www.oecd.org/ctp/glossaryoftaxterms.htm> Accessed on 10 October 2018.
[12] Hamish Russell and Gillian Brock, *Abusive Tax Avoidance and Responsibilities of Tax Professionals,* Journal of Human Development and Capabilities (2016) p. 279
[13] Alan Gunn, *Tax avoidance,* 76 Mich. L. Rev. 733 (1978) p. 734
[14] A. Miller and L. Oats, *Principles of International Taxation,* Fifth Edition (Bloomsbury Professional Ltd 2016) p. 16
[15] OECD, *International Tax Avoidance and Evasion – Four Related Studies,* (Paris 1987)

business purposes and by the clear indication of benefiting of certain legal loopholes in tax systems. That is why jurisdictions try to fight tax avoidance and prevent such arrangements. Even though countries have consistently recognised the right of taxpayers to plan their taxes by means that are in accordance with the law. However, countries have also found that tax laws should be designed to prevent their avoidance by the use of transactions that have no business purpose.

2.1.3 Tax Planning:

Tax planning and tax avoidance both carry on arrangements which involve tax reduction and they are in compliance with the law. Tax planning, however, is what we might call 'accepted tax avoidance'. Arrangements that involve tax planning are usually intended by the legislator, they have the aim of reducing the tax liability, but also, they are not purely enacted for tax benefits. Tax planning is what recognised as acceptable tax avoidance. The UN '*Committee of Experts on International Cooperation in Tax Matters*' differs between acceptable tax avoidance and unacceptable tax avoidance, where unacceptable tax avoidance is made through transactions or practices that is not intended by the legislator and has an artificial structure. On the other hand, acceptable tax avoidance or tax planning consists of activities that reduce the tax liability to a limited extent which does not go far beyond the purpose of the legislator. Tax planning is seen as a compliant behaviour, where instead, tax avoidance falls under a grey area.[16] Tax planning is defined as an "*Arrangement of a person's business and/or private affairs in order to minimize tax liability.*"[17] Still, the distinction of tax planning and tax avoidance may depend on domestic rules of each jurisdiction. Tax planning, accordingly, is a legal, legitimate and regular employment of tax rules with the purpose of minimising the tax liability.

Nevertheless, tax planning may go beyond the so-called acceptable tax avoidance and reach unintended results. Tax planning "*may reach a point beyond which it cannot be tolerated within a legal system intended to conform to principles of justice*."[18] Arrangements that goes beyond what is acceptable are referred to by 'aggressive tax planning', such arrangements may fall under tax avoidance.[19] The OECD has brought the term in the context of base erosion and profit shifting project (Starting Now 'BEPS') and it may seem hard to be distinguished. Aggressive tax planning refers to arrangements that 'push the limits' of acceptable tax planning.[20] Tax planning may also be subdivided into substantive and formal tax

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[16] Institute of Business Ethics, *Tax Avoidance as an Ethical Issue for Business,* (April 2013) p. 1, available at <https://www.ibe.org.uk/userassets/briefings/ibe_briefing_31_tax_avoidance_as_an_ethical_issue_for_business.pdf>

[17] OECD, *Glossary of tax terms,* available at <http://www.oecd.org/ctp/glossaryoftaxterms.htm> Accessed on 10 October 2018.

[18] K. Vogel, *Klaus Vogel on Double Taxation Conventions,* (Kluwer 1997) p. 117, para. 78.

[19] Lydia G. O. Juarez and Ridha Hamzaoui, Common Strategies against Tax Avoidance: A Global Overview, in M. Cotrut, *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures,* Volume 2 (IBFD 2015) p. 6

[20] CA: Canada Revenue Agency, *Tax Avoidance,* available at <https://www.canada.ca/en/revenue-agency/campaigns/tax-evasion-no-borders.html>

planning. Where the former is seeks to substantially change or give up the economic activity, and the latter seeks only to reduce the tax liability on the economic activity as low as possible.[21] Moreover, international tax planning can be subdivided into one that aimed at reduction or avoidance of double taxation and another that is aimed at avoidance or reduction of single taxation.[22]

In the end, MNEs are encouraged to pay their fair share of taxes and to contribute to the economy of the countries that offered them the infrastructure to perform their services. Accordingly, they should be blamed when refraining from paying the fair share. However, the question remains why MNEs should not benefit from the difference of tax regimes and why jurisdictions do not enact rules to tackle such activities. The impact of aggressive tax planning or tax avoidance is severely detrimental, and measures should be taken to prevent such schemes.

[21] D. Endres and C. Spengel, *International Company Taxation and Tax Planning,* (Kluwer Law International BV 2015) p.392
[22] Ibid, p.394

3. The Negative Impact of Aggressive Tax Planning/Tax Avoidance:

Recently, the public witnessed huge leaks which highlighted huge amounts of taxes being avoided through complex financial arrangements by large multinational enterprises and famous individuals. All information made available to the public and to main stream media. Highly significant information were mentioned in several NGOs reports which contributed to revealing the enormous amounts of money that MNEs are keeping offshore. Avoidance schemes are not being applied just in the last couple of years, instead they are taking a place since a long time and the leaks have proved that. In 2012, Tax Justice Network, suggested that US$21 to $32 trillion were hidden in tax havens worldwide.[23] Oxfam and Global Financial Integrity[24], estimated that developing countries lose between US$100 billion to $160 billion annually due to corporate tax dodging. The most famous and world-largest MNEs such as Vodafone, Amazon, Google, Starbucks and Microsoft have been scrutinised and investigated recently.[25] Despite the fact that their aggressive tax planning practices were according to the letter of law, several questions were raised. Governments and the public were highly concerned and outraged, especially where MNEs were avoiding millions in taxes.

Starbucks, for instance, was accused of not paying income tax in the UK between 2009 and 2012 to the extent that it had paid a total of just £8.6 million pounds in the UK for over the last 14 years by the time of the leaks.[26] Google was also questioned about their tax payments. The company generated the amount of US$18 billion in revenue in the UK in the period between 2006 and 2011 and paid just around US$16 million in corporate income tax in the UK in the same period.[27] Google was accordingly accused of taking advantage of tax rules loopholes to shift profits to low or no tax jurisdictions.

Likewise, several large accountancy firms were also accused of providing multinational firms with tax avoidance schemes. After the so-called Luxemburg leaks, the *International Consortium of Investigation Journalists* (ICIJ)[28] published, in November 2014, a correspondence between the Luxembourg Inland Revenue and PwC, one of the big four accountancy firms, indicating the accountancy firm PwC secured deals with the Luxembourg tax authorities for 343 MNEs including world-large ones such as Amazon,

[23] James S. Henry, *The Price of Offshore Revisited,* Tax Justice Network (July 2012) p. 5, Available at: <https://www.taxjustice.net/wp-content/uploads/2014/04/Price_of_Offshore_Revisited_120722.pdf>
[24] Ann Hollingshead, *The Implied Tax Revenue Loss from Trade Mispricing,* (February 2010) p. 1, Available at: <https://www.gfintegrity.org/storage/gfip/documents/reports/implied%20tax%20revenue%20loss%20report_final.pdf>
[25] Christiana HJI Panayi, *Advanced Issues in International and European Tax Law,* (Hart Publishing 2015) p. 11
[26] Tom Bergin, Special Report: How Starbucks Avoids UK Taxes, (Reuters – October 2012) available at: <https://uk.reuters.com/article/us-britain-starbucks-tax/special-report-how-starbucks-avoids-uk-taxes-idUKBRE89E0EX20121015>
[27] UK House of Commons, *Tax Avoidance-Google,* Committee of Public Accounts (London June 2013) p. 5, available at: <https://publications.parliament.uk/pa/cm201314/cmselect/cmpubacc/112/112.pdf>
[28] For more on Luxembourg leaks see: <https://www.icij.org/investigations/luxembourg-leaks/>

Ikea, Vodafone Pepsi etc. Some documents suggested that some large multinational firms were subject to an effective tax rate below one per cent on profits channelled into Luxembourg.[29] Following the Luxembourg leaks, the UK *Public Accounts Committee* mentions that the leaks suggested that "*PwC had advised many multi-national firms to adopt similar complex financial structures for the purpose of avoiding tax.*"[30] On the other hand, In a public statement PwC replied to the UK Public Accounts Committee accusations stating that "*We stand by the evidence we gave to the Public Accounts Committee and disagree with its conclusion about the work we do. ... We agree the tax system is too complex, as governments compete for investment and tax revenues. We take our responsibility to build trust in the tax system seriously and will continue to support reform.*"[31]

Apple, one of the world's largest MNEs, was also questioned by the US Senate for its complex tax practices. It is believed that Apple was able to shelter the amount of US $44 billion from taxation anywhere in the world.[32] In the opening statement of Senator McCain in the US Senate on '*Offshore Profit Shifting and the U.S Tax Code-Part2 (Apple INC.),*'[33] it was mentioned that "*Apple has negotiated a tax rate in Ireland of less than 2 per cent. Apple used loopholes to defer paying taxes on $44 billion in taxable offshore income.*"[34] In addition, the OECD BEPS project has estimated that the amount between US$100 and $240 billion per year falls under the scope of avoidance by MNEs.[35]

The scandals were not only targeting MNES, but also famous individuals where Media took the advantage of the leak and reviled information which indicates that several famous individuals were avoiding tax. Several famous football players such as Lionel Messi, Cristiano Ronaldo, Neymar da Silva Santos, Jose Mourinho and Javier Mascherano were either accused or convicted of participating in schemes designed to avoid taxes.[36]

Although states are going to collect less tax revenue due to the base erosion of their taxable base through tax avoidance schemes. It is significant to clarify that tax avoidance and aggressive tax planning do not harm governments only but also the public including other taxpayers. Taxpayers committing avoidance practices and abusively planning their taxes would pay less taxes and accordingly stay with

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[29] Christiana HJI Panayi, *Advanced Issues in International and European Tax Law,* (Hart Publishing 2015) p. 16

[30] UK House of Commons, *Tax Avoidance: the role of large accountancy firms (follow-up),* Committee of Public Accounts, 38th Report of Session 2014-15, (London February 2015) p. 7 Para. 3, available at: <https://publications.parliament.uk/pa/cm201415/cmselect/cmpubacc/1057/1057.pdf>

[31] PwC statement on the 38th Report of the Public Accounts Committee, available at: <https://pwc.blogs.com/press_room/2015/02/my-entry.html>

[32] Antony Ting, *iTax-Apple's International Tax Structure and the Double NON-Taxation Issue,* British Tax Review (Thomson Reuters 2014) p. 40-41

[33] US Senate Permanent Subcommittee on Investigations of the Committee on Homeland Security and Government Affairs, *Offshore Profit Shifting and the U.S Tax Code-Part2 (Apple INC.),* (Washington 2013), available at: <https://www.govinfo.gov/content/pkg/CHRG-113shrg81657/pdf/CHRG-113shrg81657.pdf>

[34] Ibid, p. 10

[35] OECD, *Measuring and Monitoring BEPS,* Action 11, (Final Report 2015) p. 15

[36] Steven A. Bank, *When Did Tax Avoidance Become Respectable,* 71 Tax L. Rev. 123 (2017) p.124

higher profits. Other taxpayers, on the other hand, that don't pursue such schemes will face higher taxes and consequently be at a competitive disadvantage. Moreover, tax avoidance and aggressive tax planning are also harmful for both developing and developed countries. While developing countries face several other problems due to their weak tax institutions, such reality indicates that they lack the resources to fight and tackle abusive tax practices.[37]

Therefore, when taxpayers avoid paying their fair share of taxes, they are harming governments and other taxpayers in both developed and developing countries. Thus, their abusive tax avoidance should be a serious concern for the public and for states' institutions. Hence, countries all over the world have recently been engaging in coordinated international efforts to tackle excessive or abusive tax avoidance practices of the world-large MNEs.[38]

[37] Hamish Russell and Gillian Brock, *Abusive Tax Avoidance and Responsibilities of Tax Professionals,* Journal of Human Development and Capabilities (2016) p. 282

[38] Allison Christians, *BEPS and the New International Tax Order,* BYU L. Rev. (2016) p. 1603

4. Domestic Anti-Avoidance Measures:

Aggressive tax planning schemes of MNEs try to exploit or manipulate mismatches in tax rules on the national and international level and even though avoidance schemes may be unethical in the eyes of many, it may represent or reflect the failure of the rules and the system. The card of ethics and aggressive tax planning is not a concrete one and attaching aggressive tax planning to an ethical failure is not always a solution. It has been mentioned that "*bad laws do not bind the conscience of man*"[39] and thus, also ethical people may pursue avoidance practices. The ethicality of tax planning is far greater than being summarised in few sentences. However, what is considered ethical for one taxpayer may not be considered the same for tax authorities or the public. Therefore, tax rules need to be clear and certain, and should precisely indicate what a taxpayer can do or cannot. Such a position may not be easy to reach, and obstacles are always being raised. However, states tend to lay down domestic measures which acts to counteract MNEs unaccepted tax avoidance and aggressive tax planning. The enactment of such measures does not just serve the prevention of tax avoidance only, but also help to the extent that it provides the clarity needed as to what is wrong and right or ethical and unethical.

States are aware of MNEs practices and their exploitive behaviour to which they take advantage of loopholes in tax systems and so many countries have judicial anti-avoidance doctrines or statutory anti-avoidance rules.[40] Doctrines and rules, in general, apply to domestic and international transactions and arrangements that contain an element of tax avoidance. Judicial doctrines, on the first hand, include sham transactions, substance-over-form, business purpose, step transactions and abuse of law doctrines. An example of judicial doctrines is, for example, when a country disregards a sham entity located in a tax haven due to the lack of genuine commercial activities. Statutory rules, on the other hand, include general anti-avoidance rules (GAARs) and specific anti-avoidance rules (SAARs), in addition to other rules that may also exist in some jurisdictions such as mandatory disclosure rules or additional reporting requirements. Domestic provisions are considered to be the primary tool for jurisdictions to which they counteract avoidance practices. Where some might say that it is dangerous to merely rely on court's interpretation of tax rules as to prevent tax schemes.[41]

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[39] Collins Udeh, *Rights, Responsibility, Law and Order in 21st Century's Civil Disobedience,* Volume 7 No. 2 (Journal of Politics and Law 2014) p. 37

[40] B. J. Arnold, *International Tax Prime,* 3ed edition, (Kluwer Law International BV, 2016) p. 112

[41] R. Maas, *Tax Avoidance in the United Kingdom, Tax planning and Anti-Avoidance Legislation: Special Report (September 2006),* (International BNA 2006) p. 11

4.1 General Anti-Avoidance Rules (GAARs):

General anti-avoidance rules are known as "*... generally statute based, providing criteria of general application, i.e. not aimed at specific taxpayer or transactions, to combat situations of perceived tax avoidance.*".[42] They are also defined as *"... domestic rules that allow the tax authorities to recharacterize a transaction or a serious of transactions that have been entered with the (sole or main) purpose of obtaining undue tax benefits.*".[43] Accordingly, such provisions are generally intended, by the legislator, to have a broad scope of application in order to deal sufficiently with avoidance practices such as international avoidance transactions. General anti-avoidance rules are *"... intended to prevent abusive arrangements that are not adequately dealt with through specific anti-abuse rules or judicial doctrines.*".[44] However, GAARs are different from other anti-avoidance provisions, where unlike other substantive rules which set out specific criteria that cover all taxpayers in a particular situation and subject them to tax. Instead, general anti-avoidance rules target taxpayers on a case-by-case basis, where each situation is analysed separately. Moreover, GAARs consider all elements of taxpayer's issue, including the taxpayer's purpose. GAARs, therefore, include objective indicators and test standards to be used as a tool for the determination of a taxpayer's purpose and consequently the taxpayer's purpose needs to be either proved or disproved.[45]

GAARs are incorporated in several countries around the world such as Australia, China, Finland, Germany, Indonesia, Peru, South Africa, Switzerland, the United Kingdom and the United States.[46] In addition to one of the oldest GAAR provision in New Zealand.[47] However, one of the main drawbacks of GAARs is the uncertainty. Taxpayers are uncertain if a GAAR could apply or not to transactions and arrangements that they take part in. Also, concerns are raised over the scope of GAARs, where they may also subject genuine business transactions due to the broad nature of such provisions. GAARs vary widely from one jurisdiction to another, and also differ between statutory or case-developed precedents, however, it has been mentioned that for an effective GAAR, regardless of their variety, it should allow "*a reassessment on the basis of a hypothetical alternative transaction different from legal form chosen by the taxpayer to minimize tax.*".[48]

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[42] Barry Larking, *IBFD International Tax Glossary,* 5th edition (IBFD 2005) p. 193
[43] Raffaele Russo, *Fundamentals of International Tax Planning,* (IBFD 2007) p. 207
[44] United Nations – 2017, *Model Double Taxation Convention between Developed and Developing Countries,* (New York 2018) Commentary on Article 1 para. 41
[45] Michael Lang, *GAARs – A Key Element of Tax Systems in the Post-BEPS World,* Volume 3 (IBFD 2016) p. 2,7-8
[46] Lydia G. O. Juarez and Ridha Hamzaoui, Common Strategies against Tax Avoidance: A Global Overview, in M. Cotrut, *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures,* Volume 2 (IBFD 2015) p. 18
[47] C. Elliffe, *Policy Forum: New Zealand's General Anti-Avoidance Rule – A Triumph of Flexibility over Certainty,* (Canadian Tax Journal 2014) p. 163-164
[48] Michael Lang, *GAARs – A Key Element of Tax Systems in the Post-BEPS World,* Volume 3 (IBFD 2016) p.4

4.2 Specific Anti-Avoidance Rules (SAARs):

Specific anti-avoidance rules, also called specific anti-abuse rules,[49] are incorporated in domestic tax regimes seeking to prevent taxpayers from being able to exploit gaps or loopholes in tax law. Countries seem to increasingly tend to have SAARs more and more, that is not surprising considering their preventative purpose.[50] Accordingly, such rules act as a potential measure to fight against tax avoidance schemes. They usually include several mechanisms which tackle abusive tax practices, mechanisms such as thin capitalisation rules, transfer pricing rules, CFC legislation, anti-hybrid rules and anti-tax havens rules.

Anti-tax haven rules exist in several domestic tax systems of different jurisdictions, and they include rules that is designed to prevent the use of tax haves. The rules works, for example, through refusing costs and expenses' deduction if such amounts are raised form transactions with entities located in tax havens.[51] For example, Germany imposes a special tax on persons who have their domicile in tax havens.[52] **Anti-hybrid rules** are intended to prevent schemes of hybrid entities and hybrid instruments. Such hybrid entities, transactions or arrangements may occur if they are treated or qualified differently in the states where they operate or being operated, and taxpayers exploit such differences. The OECD in its BEPS project devoted one of its action plans and developed recommendations to be inclined as domestic rules under Action Plan 2 "*Neutralising the Effects of Hybrid Arrangements*".[53] **Thin capitalisation rules** are intended by the legislator to prevent "*non-resident shareholders of resident corporations from using excessive debt capital to extract corporate profits in the form of deductible interest rather than non-deductible dividends*."[54] Such schemes occur when the parent company is resident in a jurisdiction different from its subsidiaries, and they carry out transactions to benefit from deductions under deductibility rules of each jurisdiction.

Transfer pricing rules are aimed at intercompany or transfer pricing which takes the form of business transactions between associated entities. Transfer pricing rules are not considered, by some countries, as international anti-avoidance rules, however, several countries elect them to be a distinct

[49] Lydia G. O. Juarez and Ridha Hamzaoui, Common Strategies against Tax Avoidance: A Global Overview, in M. Cotrut, *International Tax Structures in the BEPS Era: An Analysis of Anti-Abuse Measures,* Volume 2 (IBFD 2015) p. 21
[50] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 54
[51] Raffaele Russo, *Fundamentals of International Tax Planning*, (IBFD 2007) p. 228
[52] B. J. Arnold, *International Tax Prime,* 3ed edition, (Kluwer Law International BV, 2016) p. 112
[53] See detailed report, available at: < https://www.oecd.org/tax/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm>
[54] B. J. Arnold, *International Tax Prime,* 3ed edition, (Kluwer Law International BV, 2016) p. 113

anti-avoidance provisions.[55] Nevertheless, transfer pricing rules may be regarded as a key tool for states to protect their corporate tax base by preventing artificial shifting of profits, which usually occur through pricing transaction too high, or too low, between entities within a group of companies to entities located in low-tax jurisdictions.[56] Yet, the drawback of transfer pricing rules is that they only apply to non-arm's length transactions and do not sufficiently address indirect transfers. Therefore, they may not cover all types of tax havens abuse.[57] **CFC legislation** is intended to protect jurisdiction's tax base from profit shifting and base erosion. It is considered to be one of the most effective methods to tackle deferral and profit shifting. Action Plan 3 in the OECD BEPS project provides best practice rules for designing stronger CFC rules. CFC rules were introduced after the second world war by the era of internationalisation of companies and their evolving to multinationals and even though they were not vital when first introduced, the last 20 year they become essential tool in tackling BEPEs activities, especially due to MNEs schemes to avoid high tax jurisdictions.[58]

Domestic rules are the first tool for governments to tackle tax avoidance practices, and states are expected to close gaps that exist in tax regimes. Although tax planning is legal and taxpayers are free to organise their tax situations in the way they see appropriate, however, taxpayers may go beyond what is acceptable and abuse the rules. Moreover, the line between what is acceptable and not acceptable is hazy and should be cleared. In fact, the existence of several legal terminologies such as aggressive tax planning abusive tax avoidance, excessive tax avoidance and other terms reflect the complexity of tax rules and avoidance practices. Therefore, there is a need for a clear development in countering avoidance and abuse schemes all together. Hence, countries are seeking to enact anti-avoidance and/or anti-abuse measures to prevent or eliminate taxpayers tax abuse practices in all of its forms.

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[55] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 51

[56] A. Miller and L. Oats, *Principles of International Taxation,* Fifth Edition (Bloomsbury Professional Ltd 2016) p. 431

[57] Ibid, 566

[58] Axel Prettl, *Influence of anti-tax avoidance rules on profit shifting and real FDI – examining CFC rules,* University of Tuebingen (February 2017) p. 1

Chapter (ii). CFC Legislation as an Anti-avoidance Tool.

1. Introductory Remarks on CFC Legislation:

A standard legal norm which exists in several jurisdictions is the taxation of worldwide income, and thus a company is taxed on the income that is derived from its residence country and also taxed on foreign sourced-income. Another taxation basis is a territorial taxing system which taxes only the company's income that is derived from sources inside the taxing jurisdiction. Taxing the company on its income regardless of the source of income is in line with Capital Export Neutrality (CEN), according to this principle a resident investor will not be encouraged or discouraged to invest domestically or in a foreign state because the investor will be subject to tax in the resident country on his worldwide income. On the other hand, a territorial-based taxation system may be in line with Capital Import Neutrality (CIN) that exempts all foreign sourced income from tax. Countries choose to apply either CEN or CIN, or they elect to use a blend method of both policies in the application of their tax system.

In order to avoid or at least defer worldwide taxation, residents of worldwide-taxation jurisdiction choose to earn their foreign source income in controlled foreign corporations, or in any other foreign legal entity, e.g. trusts. Such scheme may be useful since companies are treated as separated legal entities from their shareholders, and therefore a foreign subsidiary is regarded as a separate taxable entity. The entity separation allows resident companies to establish subsidiaries in foreign jurisdictions and consequently subsidiaries are treated as separated foreign entities. Hence, the parent's company jurisdiction is not able to tax the subsidiary income until the repatriation of the income to the parent resident company. MNEs try to exploit the legal norms, where a parent company could keep the income of the foreign subsidiary away and delay the parent's jurisdiction taxation on that delayed income. This behaviour by multinational enterprises is called tax deferral.[59] In a worldwide-taxation system, the parent company's jurisdiction cannot tax the actual investment in the foreign company, however, the income of such foreign investments is the subject of tax. Nevertheless, the jurisdiction of the parent company is not able to tax the foreign income until it is distributed back to the resident shareholders of the foreign company. Hence, MNEs choose not to distribute any dividends to the parent resident company and benefit from delaying tax liability and consequently erode the taxable base of the parent company's jurisdiction.

[59] Gerhard Kraft and Diana Beck, *Fifty Years of Subpart F Revisited in the Light if Modified Economic Conditions,* (Kluwer Law International BV 2012) p. 684

Deferral is not the only problem that may result of MNEs practices and there are different issues which result from such tax norms. First, companies tend to defer the repatriation of dividends to resident shareholders of the foreign company and, as a result, delay the tax on such dividends. Also, in cases of substantial interest in the foreign corporation, many countries exempt the foreign source income from tax in the resident country of the shareholder.[60] Second, tax rates are different from one jurisdiction to another, in addition to the existence of tax havens and preferential tax regimes. Thus, it is attractive for MNEs to reallocate their income in a low or no tax jurisdiction. The reallocation of income will, most likely, harm the taxable base of the shareholder's jurisdiction and will reduce the tax revenue of the parent jurisdiction.

Deferral may impact different jurisdiction in different ways, each depending on the situation and the tax system of each jurisdiction. For instance, deferral could mean the mere delay of tax imposition of the parent's jurisdiction on the foreign sourced income and therefore the tax is not avoided but simply delayed. However, some companies may choose not to distribute the dividends of the subsidiary income at all and reinvest it instead. Moreover, deferral of foreign income, in some jurisdiction, may provide an opportunity for the parent company to benefit from tax exemption on the deferred income.[61] Therefore, deferral may result of tax deferral and may also result in tax avoidance.

Moreover, MNEs practices are not limited to deferral. MNEs practices may result in both base erosion and profit shifting. Generally, MNEs may choose to simply keep foreign source income away and benefit from tax delay. However, MNEs may also choose to divert the income of a resident company to a foreign non-resident company that is located in a low, or no, tax jurisdiction which would lead to the erosion of the taxable base of the resident company. Consequently, and due to the gradual growing use of tax havens[62] and massive erosion of many countries tax base, various jurisdictions decided to design their tax system in a manner that tackles such schemes and to enact tax rules which protects the national tax base of the country. Moreover, jurisdictions started to introduce, or already have, domestic anti-BEPS measures to prevent MNEs of pursuing BEPS practices that are harmful and lead to negative consequences for jurisdictions.

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[60] B. J. Arnold, *International Tax Prime,* 3ed edition, (Kluwer Law International BV, 2016) p. 118
[61] Ibid, p. 119
[62] M. Lang, Aigner and Scheuerle, *CFC Legislation, Tax Treaties and EC Law,* (Kluwer Law International B.V. 2004) p. 16

Controlled Foreign Corporation legislation (From Now CFC legislation[63]) subject the shareholders of a controlled foreign corporation to tax on their pro rata share of the CFC income.[64] Under CFC legislation resident taxpayers are taxed on the income of the shares of the controlled foreign corporation having them being in direct or indirect control. Although the income is arising outside the resident's shareholders territory, CFC legislation taxes CFC income in the hand of the resident taxpayer. However, the application of the CFC legislation follows specific rules and criteria which may be different from one state to another.

The very first CFC legislation was enacted in the U.S in 1962 under the name of 'Subpart F' rules.[65] Some years later CFC legislation was incorporated in many other domestic jurisdictions around the world including; USA (1962), Germany (1972), France (1980), UK (1984) New Zealand (1988), Finland and Portugal (1995), Australia (1990) and Brazil (2001).[66] The OECD have also recommended the introduction of CFC legislation in the 1996 Report on '*Controlled Foreign Company Legislation (Studies in Taxation of Foreign Income)*',[67] and in the 1998 report on '*Harmful Tax Competition; An Emerging global Issue*'.[68] Nonetheless, although several jurisdictions around the world introduced CFC legislation, they were believed to not be working effectively as recent schemes of profit shifting to affiliates in a low or no tax jurisdiction has increased.[69] Therefore, after the G20/OECD BEPS initiative,[70] the OECD dealt with the issue of base erosion and profit shifting and introduced Action plan 3[71] which is solely aimed at strengthening CFC rules.

Features and criteria of CFC legislation are different in each jurisdiction, nonetheless, many jurisdictions share similar standard features. That is sometimes justified due to the influence of the 1996 report of CFC legislation.[72] The scope of CFC legislation may be a broad one that targets all the income of the CFC, such as active and passive income (e.g. dividends, interest and royalties), or may be limited and aimed at some categories of the CFC income. Generally, passive income, which also called 'tainted income', is easier to shift to a low, or no, tax jurisdiction, and for that many CFC legislation are designed

[63] The terms CFC legislation, CFC rules and CFC regimes will be used interchangeably throughout this work. However, all terms have the same meaning.
[64] M. Lang, Aigner and Scheuerle, *CFC Legislation, Tax Treaties and EC Law,* (Kluwer Law International B.V. 2004) p. 17
[65] Ibid, p. 25, and I.R.S. 4.6.1.7.1 (05-05-2006) Controlled Foreign Corporations (CFC) Subpart F. <https://www.irs.gov/irm/part4/irm_04-061-007>
[66] Ibid, p. 25
[67] OECD, *Controlled Foreign Company Legislation (Studies in Taxation of Foreign Income),* (OECD, 1996) p. 120-122
[68] OECD, *Harmful Tax Competition; An Emerging Global Issue,* (OECD 1998) para. 91.
[69] Ana. P. Dourado, *The Role of CFC Rules in the BEPS initiative and the EU,* (Thomson Reuters 2015) p. 341
[70] OECD, *Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan),* (OECD/Paris 2013) available at: <https://www.oecd.org/ctp/BEPSActionPlan.pdf>
[71] OECD, *Designing Controlled Foreign Company Rules*, Action 3 (2015 Final Report) available at: <http://www.oecd.org/tax/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report-9789264241152-en.htm>
[72] OECD, *Controlled Foreign Company Legislation (Studies in Taxation of Foreign Income),* (OECD, 1996) p. 343

to target only CFCs passive income. However, not all CFC legislations target only passive income as we are going to see in the coming description of CFC rules.

CFC legislation may not be the one and only effective solution for all schemes of base erosion and profit shifting, but it is one of the sufficient measures to tackle such practices and to protect the taxable base of the affected countries. Since countries enact several anti-tax avoidance and anti-BEPS measures, consequently, most of the countries have introduced CFC rules into their tax legislation, or they are on the way to introduce it.

2. The Rationale Behind CFC legislation.

CFC legislation, when first enacted in the U.S under 'Subpart F', was a protection tool for the taxable base of the resident's state and it was only associated with a worldwide taxing system.[73] The US 'Subpart F' rules were introduced to tackle deferral possibilities in tax havens, and to limit multinational enterprises of exploiting the overlap between legal systems and their interaction with international agreements. The rules aimed at prevention MNEs of reducing or the eliminating of tax liabilities of multinational related entities through the use of deferral.[74]

Although CFC legislations share similar rules and features, the objective of CFC legislation varies between countries, and also varies from the time it was enacted and in the current time. In addition to preventing the US residents of accumulating income in foreign related companies and benefit from tax deferral, CFC legislation in other jurisdictions aims at preventing profit shifting of domestic source income to foreign low-tax jurisdictions. Moreover, Arnold previously noted that CFC legislation may be linked to dividends taxation in the resident country.[75] According to that, CFC legislation is associated with how jurisdictions relive foreign source income from taxation. If a jurisdiction elects to subject foreign sourced income to tax, then CFC rules are designed to prevent deferral of the resident's country tax on the accumulated foreign undistributed profits. On the other hand, if a jurisdiction elects to exempts foreign source dividends from tax, then CFC rules are designed to prevent the resident companies from shifting their profit to a foreign non-resident company. The rules, in the latter case, intend to prevent the re-allocation of certain domestically earned income to a foreign-controlled corporation that is located in a low-tax jurisdiction, where the resident shareholders would repatriate the diverted income to the residents' country and benefit from tax exemption on foreign source dividends.

Subsequently, CFC legislation serves as a mechanism to tackle deferral in some cases and to prevent profit shifting in some other cases. Additionally, both objectives do not per se contradict the capital export neutrality policy, whereby all income should be taxed equally regardless of its source. However, CFC legislation connection to these two slightly different concepts "*has been concealed in the confusion of deferral and profit shifting under the broad concept of avoidance*".[76]

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[73] G. Kofler, '*CFC Rules*' in M. Lang, P. Pistone, J. Schuch, C. Staringer (eds), *Common Consolidated Tax Base,* (Linde Verlag Wien, 2008) p. 727-729
[74] Gerhard Kraft and Diana Beck, *Fifty Years of Subpart F Revisited in the Light if Modified Economic Conditions,* (Kluwer Law International BV 2012) p. 683
[75] B. J. Arnold, *A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules,* 65 (3) (Tax L Rev 2012) p. 475-476
[76] Daniele Cané, *Controlled Foreign Corporation as Fiscally Transparent Entities. The Application of CFC Rules in Tax Treaties,* (World Tax Journal 2017) p. 525

As an anti-tax avoidance regulation, CFC legislation may be introduced to tax income that is not derived directly from commercial or industrial activities, such as passive income.[77] Such objective has the purpose of limiting the use of companies incorporated in low-tax jurisdiction as base companies for the diverted or deferred income. Many jurisdictions apply CFC legislation to counteract the use of tax haven entities for tax avoidance purposes, as it is intended to stop the use of base company income and diverted passive income in related entities located in tax havens. In other words, CFC legislation may not be always targeting active income derived from the CFCs business activities.[78] Although the general policy of the U.S. legislation was to prevent deferral, that benefit of the U.S 'Subpart F' was achieved by preventing tax deferral between related companies through counteracting the accumulation of low-taxed income in related foreign entities. However, the policy objectives of CFC legislation have been changing throughout the time. Over the years, the scope of CFC legislation was narrowed and widened depending on the purpose, adding on, the U.S shift to a territorial tax system does raise doubts over CFC legislation objective in terms of tax deferral, since a territorial tax system taxes only domestic source income.[79] Nevertheless, CFC legislation could still play an essential role in preventing profit shifting and base erosion.

It is interesting to note that even though CFC legislation may be similar in structure and use in many jurisdictions, still the objectives tend to vary from one jurisdiction to another. For instance, one of the objectives of the UK CFC legislation is aimed at minimising taxpayer compliance burden. Canadian CFC legislation, enacted 1972, aims at taxing passive foreign accrual property income (FAPI). Australian CFC legislation, enacted 1990, was aimed at tackling tax deferral,[80] however, under the new amendment in 2016, they are targeting only passive income of CFCs.[81]

Worldwide tax system is, generally, more commonly used as a structural basis for CFC legislation. German CFC legislation could be considered one of those organic bases and may help to show the evolving objective of CFC legislation. German resident companies pay tax on their worldwide income, however, income from permanent foreign establishments and inter-company dividends are tax exempt in Germany. Thus, the primary purpose of the German CFC legislation was to tackle tax deferral and prevent German resident shareholders of retaining income in foreign entities. Today, German CFC legislation is aimed at taxing only passive income and the prevention of growing use of low- (or no) tax jurisdiction.

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[77] Mark Heidernreich, '*CFC Rules as an Instrument to Counter Abuse*' in K. Simader, E. Titz, *Limits to Tax Planning,* (Linde 2013) p. 223

[78] Daniel Sandler, *Tax Treaties and Controlled Foreign Corporations,* (Kluwer Law International 1998) p. 9

[79] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 26

[80] Ibid, p. 27

[81] UK Inland Revenue Department, *Tax Information Bulletin,* Vol. 28 No. 3 (2016) p. 49, available at: <https://www.classic.ird.govt.nz/resources/5/3/53d2ea0c-af9c-4dbb-9f9f-65aca0dbced8/tib-vol28-no3.pdf>

Where active income became disregarded in the German CFC legislation.[82] On the other hand, France, which taxes corporate income on a territorial basis, seeks, by the application of CFC rules, to tax foreign passive income which is linked to French resident companies that derive domestic income. Moreover, CFC legislation does not apply to passive income that is connected to French companies' income derived from sources outside France.[83]

Recently, CFC legislation was brought under the OECD/G20 initiative on 'Base Erosion and Profit Shifting'[84] with the purpose of strengthening CFC rules. The objective of CFC legislation under the work of the OECD was to develop rules that serve as an anti-BEPS mechanism. In the OECD report on action plan on base erosion and profit shifting, it was mentioned that controlled foreign company rules:

"*respond to the risk that taxpayers with a controlling interest in a foreign subsidiary can strip the base of their country of residence and, in some cases, other countries by shifting income into a CFC. Without such rules, CFCs provide opportunities for profit shifting and long-term deferral of taxation*."[85]

In conclusion, CFC legislation seems to have various objectives in different jurisdictions, and each of the objectives depends on the tax system of jurisdictions. In consequence, CFC legislation in a territorial-based tax system is aimed at, mainly, preventing profit shifting, where, on the other hand, CFC legislation in a worldwide-based tax system is broader in scope and therefore is aimed at both the prevention of profit shifting and the protection of tax base by ending deferral and preventing base erosion.

[82] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 27-323-324
[83] Ibid. p. 27-28
[84] OECD, *Action Plan on Base Erosion and Profit Shifting,* (OECD 2013) p.16
[85] OECD, *Designing Controlled Foreign Company Rules*, Action 3 (2015 Final Report), p. 9 (Starting Now 'Final report')

3. CFC Rules and the OECD recommendations:

While CFC legislation may vary from one jurisdiction to another, they are all generally defined using specific criteria which covers all features of CFC legislation. Such as "(*i) Control, (ii) effective level of taxation (iii) activity, (iv) type of income of the CFC*".[86] For example, one of the primary criteria that the countries use to see whether CFC rules should apply, or not, is the effective level of taxation in the CFC country. That is because if the CFC is located in a jurisdiction of an equal or higher tax rate in comparison with the parent jurisdiction's tax rate, tax deferral or profit shifting is, probably, not the case. However, countries apply various tests to be able to determine the effective level of taxation in the CFC country. Likewise, some countries create black, grey and white lists to wish they indicate if the CFC is subject to a low or high tax. Accordingly, 'Black List' is for countries with no or low tax rates and are therefore deemed to be within the scope of CFC rules, 'Grey List' for countries that may or may not offer low taxation and there could be in the scope of CFC rules and 'While List' for countries that have high tax rates and therefore are not targeted by or outside the scope of CFC rules.[87] A common feature CFC legislation is that they target all of the CFC income or just a portion of the undistributed profits of the CFC income in the hands of the controlling shareholders.[88] Furthermore, even though CFC legislation only apply to foreign corporations, or similar entities, that are under the direct or indirect control of one or more resident shareholders. However, the definition of control varies depending on the jurisdiction.[89]

Before going into details about the characteristics of CFC legislation, it is quite relevant to understand the *status quo* of international tax rules and the recent development, mainly, by the OECD. Up until now, some countries do not have CFC legislation in their tax systems. However, although the majority of the countries do have CFC rules contained in their tax system, the rules, in several jurisdictions, proved that they are not strong enough to prevent tax avoidance and cannot comprehensively eliminate base erosion and profit shifting (BEPS) situations. Subsequently, harmful tax practices and international tax issues are again on the top of the political agenda. There are several reasons for highlighting tax issues, still, the increased integration of the international market and national economies is one of the main policy players.

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[86] Mark Heidernreich, '*CFC Rules as an Instrument to Counter Abuse*' in K. Simader, E. Titz, *Limits to Tax Planning,* (Linde 2013) p. 223
[87] B. larking, ed., *International Tax Glossary,* 5th edition, (IBFD 2005), p. 92
[88] G. Kofler, '*CFC Rules*' in M. Lang, P. Pistone, J. Schuch, C. Staringer (eds), *Common Consolidated Tax Base,* (Linde Verlag Wien, 2008) p. 725
[89] Ana. P. Dourado, *The Role of CFC Rules in the BEPS initiative and the EU,* (Thomson Reuters 2015) p. 343

It is a global believe that there is a need for new and developed international tax rules. The OECD on their part already started working on the development of international tax rules under the OECD Action Plans project. The OECD stated:

"*weaknesses in the current rules create opportunities for base erosion and profit shifting (BEPS), requiring bold moved by policymakers to restore confidence in the system and ensure that profits are taxed where economic activities take place and value is created*."[90]

BEPS project is addressing tax problems that are among the toughest in the international tax regime. It is not the first time these taxation issues are being discussed, the OECD, the EU, the UN and other international organisations have already extensively worked on similar and, sometimes, identical issues to what is covered by the BEPS project. However, the same issues are not sufficiently countered, and there is an evolving need for further development. The growing of corporate tax avoidance has recently acquired the attention of political leaders, and that highlights the real problems that exist in an international income tax regime "*whose contours were formed in the 1920s and have not changed materially since*.".[91] Besides, the OECD action plan report, specifically, mentions that CFC rules were not significantly worked on in the past.[92]

The OECD's BEPS Action Plan Project consists of 15 action plans, and these action plans discuss different topics such as neutralising the effects of hybrid mismatch arrangements, limiting base erosion involving interest deduction and other financial payments , in addition to designing efficient controlled foreign companies (CFC rules).[93] The BEPS initiative lays down three different norms in its action plans, ranging between 'minimum standards', 'recommendations' and 'best practice'. The initiative, also, may be operationalised in all countries having members, or not, of the OECD.[94]

BEPS project, in specific, action plan 3 (Starting Now 'final report') discusses CFC rules, and it spots the fact that several MNE groups can establish non-resident affiliates and shift their income to them, and many of these affiliates are not established based on business-related reasons instead created wholly or partially for the sole avoidance of tax. Therefore, CFC rules and other anti-deferral rules are created to

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[90] OECD, *Action Plan on Base Erosion and Profit Shifting,* (OECD 2013) p 3
[91] H. J. Ault, W. Schon and S. E. Shay, *Base Erosion and Profit Shifting: A Roadmap for Reform,* (68 Bull. Int'l Tax 2014) p. 275
[92] OECD, *Action Plan on Base Erosion and Profit Shifting,* (OECD 2013) p 16
[93] Ibid, p. 16
[94] Allison Christians, *BEPS and the New International Tax Order,* BYU L. Rev. (2016) p. 1604-1605

help jurisdictions tackle BEPS activities by enabling them to tax income earned by foreign affiliates if certain conditions are met.

The intention of the OECD, in the final report of CFC rules, is to help countries that do not have CFC rules to enact CFC rules using the OECD recommendations and to allow countries who already have CFC rules to 'modify' or 'align' their current rules with the OECD recommendations. The final report is divided into six different part under the name of building blocks, and they include; "*(i) rules for defining a CFC (including a definition of control), (ii) CFC exemption and threshold requirement, (iii) definition of CFC income, (iv) rules for computing income, (v) rules for attributing income (vi) rules to prevent or eliminate double taxation.*"[95]

Bearing in mind the previously enacted CFC rules and the evolving improvement by the OECD, we are going to explore, next, the criteria that is characterised as best practice and should exist in order to apply CFC rules and how they should function. In other words, we are going to discuss the features of CFC legislation and in which circumstances the legislation is applied. In the final report of Action Plan 3, the OECD report contained what is called 'best practice'[96] of a strong CFC legislation.

We are going to explore the six building blocks, in addition to different countries' CFC legislation features. This will give us a better understanding of what is CFC legislation, how it is applied in some countries and what are the OECD recommendations for a stronger CFC legislation. In each of the sub-chapters, we are going first to present the OECD recommendations, followed by some country's national CFC legislation (if possible).

3.1 Action 3 policy consideration and objectives:

It is agreed that tax rules should be strong and in order to reach well-structured rules there is a need to act according to that purpose by all of the people concerned. The OECD in several occasions stated that policymakers are required to make bold moves to restore confidence in the system. The ultimate goal for the tax reforms that are taking place nowadays in most of the world's jurisdictions are aimed at taxing profits in locations where the economic activity is located, and the value is created. Nevertheless, countries that acknowledge the need to restore confidence in the system should bear in mind preserving competitiveness.

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[95] Final Report op. cit. p. 11

[96] Daniel W. Blum, *Controlled Foreign Companies: Selected Policy Issues – or the Missing Elements of BEPS Action 3 and the Anti-Avoidance Directive,* INTERTAX, Volume 46 Issue 4 (Kluwer Law International BV 2018) P. 298

Tax rules harmonisation is not the topic nor the efforts of the international community at present. Further, CFC legislations are different from one jurisdiction to another. Hence, and since the OECD is just providing recommendations to design better and stronger CFC rules. The OECD provided shared policy consideration and other specific policy consideration in an attempt to bring CFC rules in different jurisdictions closer. In addition to retaining the freedom of jurisdictions to enact their own CFC rules according to their tax policy considerations.

The final report of the OECD mentioned four shared policy considerations, and each of the policy considerations should be maintained when the respected jurisdictions are enacting their CFC legislation. The first consideration refers that CFC rules are not enacted to raise revenue for jurisdictions which apply CFC rules. Instead, they are rules that are deterrent in their character, which means that they are designed to protect the revenue by preventing profit shifting and long-term deferral. The second consideration refers that it is important to make it clear that CFC rules are not a 'backstop' for transfer pricing rules. It is a 'misleading' terminology and should be distinguished. CFC rules do not always capture the income that is captured by transfer pricing rules, and the opposite is also correct. Each of the rules are designed to capture their intended income, although they may sometimes capture the same income. Thus, neither CFC rules eliminate transfer pricing rules, nor the opposite is correct. The third consideration refers that CFC rules should be designed to prevent avoidance while reducing administrative and compliance burden effectively. Therefore, a balance between practical and flexible rules should also be preserved. This policy consideration is maintained in the report by providing several mechanisms that serves to reduce compliance and administrative burdens. The fourth consideration indicates that since CFC rules raise the concern of double taxation, this concern should be limited, and rules should be designed to prevent double taxation of occurrence and provide rules to eliminate it in the same manner.[97] Moreover, additional consideration should be respected where CFC rules are in jurisdictions with a worldwide-based tax system are designed differently, and aimed at other targets, from CFC rules in a jurisdiction with a territorial-based tax system.[98] However, it is quite hard to find a system that falls entirely in one of the mentioned systems.

All said aside, the rules should be designed keeping in mind the need to (i) strike a balance between taxing foreign income and maintaining competitiveness. Strict CFC rules raise concerns for both, the jurisdictions with strict CFC rules, and multinationals that are located in such jurisdictions, to be at a

[97] Final Report op. cit. p. 13-15
[98] Gilles V. Hulles, *Current Challenges for EU Controlled Foreign Company Rules,* Bulletin for International Taxation (IBFD 2017) p. 719

competitive disadvantage with other jurisdictions with, or with multinationals located in jurisdiction with, no CFC rules or a less strict CFC rules. Therefore, the mitigation of this concern is needed. Hence, the OECD suggests exempting 'active income' from the scope of CFC rules and it also believes it will be of the benefit of all the parties if CFC rules of all countries are designed similar to each other. Furthermore, the rules should consider (ii) preventing base stripping by protecting the parent jurisdiction and also preventing foreign-to-foreign stripping. CFC rules that focus, only, on the protection of the parent jurisdiction might not be effective in tackling BEPS practices.[99]

3.2 Definition of CFC:

Two questions may come up when presenting CFC rules. One, what a foreign corporation is? Another, what control is? Looking at the name of the rules, some might say that the rules should apply just on corporations, and not any other legal entities. Even though the name may exclude other legal entities from the scope of CFC rule, still, it is not the case. For the first question, the OECD give several considerations for what type of legal entity qualifies as a CFC. It has been mentioned that *"... many countries include trusts, partnerships and PEs in limited circumstances to ensure that companies in the parent jurisdiction cannot circumvent CFC rules just by changing the legal form of their subsidiaries*."[100] French CFC rules, for example, include branches established in the foreign jurisdiction.[101] While transparent entities are recommended not to be in the scope of CFC rules if their income is already taxed on the level of the parent company, such transparent entities could be treated as CFCs if their income raise 'BEPS concerns' and therefore is not taxed by the parent company. Permanent establishments (PEs), also, could be subject to CFC rules if they are exempt from tax in the parent's jurisdiction and might raise concerns of BEPS activities. PEs may raise concerns, for instance, if they are connected to a controlled foreign corporation. Another issue was raised on the final report, which is the classification of entities in the case of hybrid mismatches. Therefore, countries need to address that issue to prevent any circumvention of the application of CFC rules.[102]

On the other hand, to answer the second question of what control is? There are two folded questions that need to be answered and combined they define control. The first, what control is and the second, how can we determine control. Accordingly, we initially need to determine the type of control and after the level of control. The final report provided different tests for the determination of control, and

[99] Final Report op. cit. p. 16-17
[100] Ibid, p. 21
[101] Thierry P. C. Pons, 'France' in, *Current Taxation of Host Country of income earned by Controlled Foreign Corporations,* (The Bureau of International Affairs, Inc 2012) p 32
[102] Final Report op. cit. p. 22-23

each of them depends on a different perception of control. A relatively simple test, for tax authorities and taxpayer, to determine control is the 'Legal Control' which examines the shareholder's voting rights in a foreign subsidiary based on the resident's holding shares of capital. For instance, Denmark considers a minimum quota of 50% of voting right to be sufficient to prove the shareholders control.[103] An alternative control is 'Economic Control' which targets the right on profits, capital and assets of a company.

We also have 'Control based on consolidation', this test tries to capture non-resident entities that are consolidated in the accounts of a resident company. Furthermore, some countries search for the decision-making person or for whom can influence the company's daily activities. That is called '*De facto control*', and it is generally used as an alternative anti-avoidance rule to guarantee that other control tests are not circumvented. The final report recommends the use of a combined approach to ensure efficiency of the rules.[104]

For the second, the final report set the level of control to be more than 50 per cent, and it also indicates that jurisdictions are free to lower the threshold below 50 per cent. However, control could be held by one or more shareholders. Therefore, in case of several minority shareholders that are 'acting together' for their interest, the main principle is that minority shareholders, which are acting together in the control of the foreign corporation, should have their interests aggregated for the control test.[105] Additionally, the report advises that both direct and indirect control should be taken into consideration, where that will narrow the opportunities of profit shifting using an intermediate holding company.[106]

For instance, for German CFC rules, control is determined if more than 50 per cent of the shares or the voting rights are held directly or indirectly by a domestic shareholder. In case of several minority shareholders, their control is aggregated for tax purposes. Since the German jurisdiction does not rely on a black, grey or white list, all CFCs may be targeted by CFC rules. German CFC rules go much tighter than the OECD recommendations when aggregating the control percentage for minority shareholders, where the shares are aggregated even if the shareholders are unaware of each other existence.[107] Moreover, if the CFC derives a certain type of income, such as 'passive income' the control criteria by

[103] M. Lang, Aigner and Scheuerle, *CFC Legislation, Tax Treaties and EC Law,* (Kluwer Law International B.V. 2004) p. 19
[104] Final report op. cit. p. 24-25
[105] Ibid, 25
[106] Ibid, 28
[107] Jorg-Dietrich K. Bruhl, 'Germany' in, *Current Taxation of Host Country of income earned by Controlled Foreign Corporations,* (The Bureau of International Affairs, Inc 2012) p. 33

domestic shareholders is not a requirement, actually even if a domestic shareholder holds just 1 per cent or less than that, CFC rules could be applied.[108]

For Portuguese CFC rules[109], the rules apply if (i) at least 25 per cent of the shares are held, directly or indirectly, by a Portuguese shareholder or, (ii) 10 per cent if at least 50 per cent or more of the CFC shares are held by Portuguese shareholders. Both direct and indirect control are realised, such as indirect participation through a representative, trustee or intermediary.[110] Here it seems that the Portuguese CFC rules went below the control level provided by the final report, however, the OECD have mentioned that countries are free to go beyond the recommendations provided.

The Australian CFC legislation considers non-resident foreign companies as a CFCs if they meet one of the three control tests in the Australian law. The 'Assumed Control' test which would qualify the non-resident foreign company as a CFC if one single Australian entity owns, or is entitled to acquire, at least 40 per cent in the foreign company. A firmer test is 'Strict Control' test, where a non-resident foreign company will be treated as a CFC if a group of five or fewer Australians entities hold together at least 50 per cent in the foreign company, regardless of the control percentage of each of them (e.g. shareholder A 10%, B 20%, C 30%). The last one is the 'De Facto' test, where a non-resident foreign company will be qualified as a CFC if five or fewer Australian entities alone or with associates reflect effective control of the foreign entity. Such control may be determined if the shareholder have power to control the appointment of the directors of the foreign company.[111]

3.3 Low Taxation and CFC exemptions:

In order to have a more effective and targeted CFC rules, it is recommended to set a tax threshold that excludes CFCs which are effectively taxed in the foreign jurisdiction. In the OECD perspective, CFCs that raise little concerns of base erosion and profit shifting are better to be excluded from the scope of CFC rules. A specific tax threshold will help to narrow the scope of CFC rules which will accommodate the rules to be more effective and aimed at CFCs that pose a high risk of BEPS.

Accordingly, there are, mainly, two measures which jurisdictions could apply. Countries may choose to apply the '*De Minimis'* threshold, or the '*Tax Rate exemption'*. Based on such exemption, a

[108] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 331-332
[109] Article 66 of *Lei N.º 442-B/88, de 30 de Novembro,* (Código IRC)
[110] Alcídio M. Ferreira, *CFC in Portugal: Still incompatible with Eu Law?,* European Taxation (IBFD 2012) p. 480
[111] Australian Taxation Office, *Foreign Income Return Guide,* (QC 51231 – 2017) p. 13-14, available at: <https://www.ato.gov.au/misc/downloads/pdf/qc51231.pdf>

de minimis amount of income may be set by the parent's company jurisdiction in order to apply, or not, CFC rules. Countries that include a de minimis income will generally exclude CFC's income from tax if the income is below a certain limit.[112] German CFC rules include a de minimis test, where the test applies if the gross 'passive income' of the CFC is less than 10 per cent of the total gross income or if it does not exceed EUR 80,000 (section 9 of the Foreign Transaction Tax Act.).[113] However, that is disregarded when dealing with a group of companies

Although the *'de minimis'* test could reduce the administrative burden, the test may lead to the rules being circumvented by the fragmentation of income. That may occur when a CFC income is portioned into different CFCs in a manner that does not exceed the de minimus threshold. The final report borrows two different rules from the German and the U.S jurisdictions to deal with such concern. German CFC rules apply anti-fragmentation rules which states that the de minimus test is subject to *"... the condition that the attributable income must not exceed the same amount at the level of the CFC and at the level of the shareholder.*"[114] By these rules, although if the CFC's income does not exceed the de minimis threshold, it would be subject to CFC rules if the aggregate CFCs income, of the same parent company, exceeds the threshold. Likewise, according to the U.S Subpart F jurisdiction, under a de minimis test, an anti-abuse rule would aggregate the CFCs income and treats it as one CFC income, where *"... a principle purpose for separately organising, acquiring, or maintaining such multiple corporations is to prevent income from being treated as attributable under the de minimis test."*.[115] The final report neither recommends for, nor recommend against, a *'De Minimis'* test or threshold. However, if a country elects to include such tests, the best practice is to combine them with an anti-fragmentation rule.[116]

The second measure is the 'Tax Rate exemption', where CFC rules exclude CFCs that pay a tax above a certain rate from CFC rules. A jurisdiction with CFC rules would set a tax rate which exempts all CFCs that pay more than the already set level and would not subject them to CFC rules. This type of concentration of the level of taxation is also called the 'designated jurisdictional approach' or 'jurisdictional approach'.[117] This exemption gives a clear certainty for taxpayers, reduces the administrative burden, and it focuses on the low-taxed CFCs rather than CFCs that are located in high-tax jurisdictions. Nevertheless,

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[112] Final Report op. cit. p. 33
[113] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 336
[114] Final Report op. cit. p. 34
[115] Ibid, p. 34
[116] Ibid, p 36
[117] OECD, *Controlled Foreign Company Legislation (Studies in Taxation of Foreign Income)*, (OECD, 1996) p. 40

the tax rate exemption will create opportunities to shift the profits to jurisdiction with slightly higher tax than the tax rate exemption. Therefore, some jurisdictions choose not to include a tax rate exemption in their CFC rules.

Moreover, countries would need to ensure that the tax rate of the CFC country is less than the one in parent's country. In order to do achieve this criterion, countries would either take the approach of comparing the tax rate on Case-by-Case approach, or they may use lists for countries with low-tax, or high-tax, rates. The OECD does recommend the existence of lists which make it easier for both taxpayers and tax administrations. However, the report additionally states that "*This approach therefore sets a presumption that a CFC is lowly taxed, but that presumption must be supported with an actual comparison of taxes paid.*"[118]

Jurisdictions would either fix a specific tax rate that a country considers low-tax rate or set a percentage or a portion of the parent's country tax rate that should be paid in the CFC country in order to be exempt of CFC rules. The OECD states that both methods act in line with tackling base erosion and profit shifting. German CFC rules, for instance, consider 25 per cent as low taxation.[119] Portugal, on the other hand, use both methods where CFCs are subject to CFC rules if they are located in one of the countries listed in the blacklist or if they pay an amount of tax that is less than 60 per cent of the tax that would have been paid if the entity is a resident of Portugal.[120] Chinese CFC rules set the level at 25 per cent, and they indicate that low taxation should be actual and 'obviously lower'.[121]

However, the OECD recommends that countries, when comparing the CFC country's tax rate to the parent country's tax rate, should determine the 'effective tax rate'. Thus, in order to prevent any circumvention of the rules, countries need to determine the actual tax paid by the CFC rather than the statutory tax rate of the CFC country.

3.4 What Income Should be Attributable and How it Should be Attributed:

When designing CFC rules, there is a need to know what income should be taxed at the level of the parent shareholder of the CFC. Although the rules should be designed in the way that serves the country's tax policy, still, they should have the anti-BEPS purpose as their primary element. That is by

[118] Ibid, p. 37
[119] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, "*The Taxation of Foreign Passive Income for Groups of Companies*" Vol.98a (2013) p. 332
[120] Ibid, p. 613
[121] Cui Xiaojing and Zhang Han, *Chinese Controlled Foreign Company Rules in the Post-BEPS Era: New Developments,* Asia-Pacific Tax Bulletin, (Volume 24 – 2018) p. 2

preventing avoidance through the diversion of domestic source income, preventing tax deferral and tackling profit shifting. Due to the different purposes and goals of the rules, different streams of income should be treated differently. A primary distinction shall be made between passive and active business income. Where active income is not considered harmful under the aspect of international competitiveness,[122] passive income, on the other hand, poses a real risk, and it is easier to be diverted to other jurisdictions.

It is believed that it is harsh to consider that all the income of the CFC to be shifted or reallocated. CFCs are not, entirely, established for tax purposes. Therefore, not all CFCs are avoiding parent's country tax. Furthermore, not all types of income may raise concerns of base erosion and profit shifting. Bearing that in mind, the OECD provides a non-exhaustive list of recommendations to what type of income should be attributable to the CFC parent's company and keeps it up to the interested countries to choose what approach suits their domestic rules and deals better with their BEPS concerns.

For the determination of the attributable CFC income, most countries choose to apply (i) categorical analysis or (ii) substance analysis. However, the OECD in its final report mentioned one more method that does not exist in any CFC legislation until now, (iii) excess profit analysis. Jurisdictions are free to choose the method that they think is better to server their CFC rules objectives and their tax system policy.

(i) Categorical Analysis:

The name could lead us to the meaning of such a method. In this method, the targeted income is divided based on categories. Accordingly, three different classifications help in determining what CFC income should be attributable. First, the 'legal classification' which targets, generally, streams of income that are mobile and easily shifted to, or reallocated in, another jurisdiction. Countries usually include in their legal classification types of income such as dividends, interests, insurance income, royalties, IP income and sales and services income. The second classification is the 'relatedness of parties' which includes in the CFC income any income that is believed to be shifted to a related party. The third one is the 'source of income', which determines the CFC income based on the source of that income. The last practice is considered as anti-base stripping, where it does not target the CFC income that is generated by the undertaking of the CFC in the CFC country. More accurately, CFC income that is generated in the parent company's jurisdiction is attributable to the parent company, or in a broader approach is to

[122] M. Lang, Aigner and Scheuerle, *CFC Legislation, Tax Treaties and EC Law,* (Kluwer Law International B.V. 2004) p. 22

attribute the CFC income that is generated from any jurisdiction different of the CFC jurisdiction to the parent company.[123]

(ii) Substance Analysis;

Many jurisdictions include this approach to determine what is characterised as CFC income. This method tests where the income was substantially generated, or as mentioned in the final report, the *"... substance analyses are generally asking the same fundamental question, which is whether the CFC could earn the income itself."*[124] There are two ways to apply the substance analysis. One is based on a threshold test and another on a proportionate analysis. The first test would exclude or include all of the CFC income if the CFC engaged in, or did not, (to a certain amount) in certain activities. In other words, the parent jurisdiction would include all of the CFC income, if the CFC income of a particular activity exceeds a certain amount. On the other hand, the parent jurisdiction will disregard all the CFC income if the income does not exceed the already set amount.

Furthermore, the proportionate analysis is based on the portion of the CFC income which results from an individual stream of income. In this analysis, if the CFC income is, for instance, 75 per cent and is generated from the CFC performed activities then just the remaining 25 per cent is included in the attributable CFC income. Although, substance analysis increases the complexity of CFC rules but still provide a more accurate result.[125] However, countries usually combine both the categorical analysis with the substance analysis in their CFC rules.

(iii) Excess Profit Analysis;

The final report mentions that this approach does not exist in any of the existing CFC rules. This type of analysis determines CFC income based on the income that is in excess of ‘normal income', and which is located in a low tax jurisdiction. The approach is most suitable for predicted income such as IP income, in this case, the ordinary income is the one that is already predicted by selling, purchasing or providing a service. Thus, the excess profits will be determined by subtracting the actual income from the ordinary income of the CFC, and the difference is considered as an excess profit and therefore a CFC

[123] Final Report op. cit. p. 43-46
[124] Ibid, p. 47
[125] Final report op. cit. p. 47-49

attributable income. Then again, this approach should be design based on the policy objectives of the enacting country of the CFC legislation.[126]

Furthermore, following the determination of the attributable income of the CFC, there are two ways to determine how the analysed income should be attributed to the parent company. Jurisdictions may choose to attribute the income based on the 'entity approach' or the 'transactional approach'. Based on the entity approach, all-or-no income is attributed to the parent company. That is if, for example, the CFC generated mostly active income and a low percentage of passive income (lower than a set amount or percentage determined by the CFC rule country), all the income of the CFC will be disregarded. Vis a vis, if the CFC generated passive income more than the fixed amount or percentage, all the CFC income is attributed to the parent company. Although this approach provides more certainty for taxpayers and reduces the administrative burden and tax compliance cost, it presents a disadvantage for the CFC that generates most of its income from active income and it may also raise concerns over fears of circumventing the rules by lowering the passive income of the CFC to be excluded from attribution.

On the other hand, based on the transactional approach, jurisdictions need to determine the attributable income by assessing each stream of income. Therefore, under the transactional approach, even if the CFC derive the majority of its income from active income, its passive income will be still attributed to the parent company. On the contrary of the entity approach, the transactional approach increases the administrative burden and compliance cost, nevertheless, it delivers a more accurate assessment of the CFC income and decreases the risk of any BEPS concerns.[127]

For instance, although Australian CFC rules taxes resident shareholders on their pro rata share of the CFCs passive income, they might not be taxed if the CFC passes the active income test. The active income test requires that the CFC income should be almost entirely derived from active business activities, which are activities that are hard to relocate in other jurisdictions.[128] Likewise, according to Chinese CFC rules, non-distributed income may be exempted from tax if it is derived due to 'reasonable business needs' such as investing in substantial production.[129]

[126] Ibid, p. 49-50
[127] Final Report op. cit. p. 51-52
[128] Alastair Macphee, *Australian Review Spurs CFC Rethink,* (10th int'l Tax Rev. 39 – 1999) p. 39
[129] Cui Xiaojing and Zhang Han, *Chinese Controlled Foreign Company Rules in the Post-BEPS Era: New Developments,* Asia-Pacific Tax Bulletin, (Volume 24 – 2018) p. 8

3.5 Rules for computing income:

After determining what is CFC income and what type of income is attributable, we need to calculate the CFC income that is attributable to the parent company. Here, there is a need to know which jurisdiction's rules are used for computing income, the parent jurisdiction rules or the CFC jurisdiction rules and whether any specific rules are necessary for computing income.[130]

There are four different options that the OECD recommendations provide for computing the CFC income. The first option considers that the CFC income should be computed based on the CFC jurisdiction's rules. However, the OECD clearly states that this option is in inconsistency with the goals of 'Action Item 3' and it may reduce the amount of attributed income. The second option considers that CFC income should be computed based using the rules of the parent jurisdiction. This option reduces the administrative cost and is in line with tackling BEPS activities of the parent jurisdiction. The third option is by allowing taxpayers choose the rules between the parent or the CFC jurisdiction to compute the CFC income. However, this option would create opportunities to circumvent the rules. Moreover, the fourth option is to use the International Financial Reporting Standards (IFRS), which does not exist in most countries with CFC rules and may increase the administrative burden and compliance cost.

Furthermore, a critical issue is raised by the final report about the losses of the CFC. The OECD recommends, what already exist in some jurisdictions, to allow the CFC to set its losses against the profits of the same CFC or to a CFC that is located in the same jurisdiction. However, it is not recommended to allow losses to be set against the parent company profits or to a CFC located in another jurisdiction to prevent any manipulation of the rules. Additionally, to avoid any 'over-taxation' the OECD recommends allowing a carry of losses backwards and forwards to be uses against profits arising in other years if such recommendation is allowed by the domestic law.[131]

3.6 Rules for attributing income:

It is the next step after calculating CFC income, which, under the final report, is explained by answering the following five questions. The answers, therefore, are considered to be the rules on how to attribute the income to the parent shareholders. (i) Which taxpayers should have CFC income attributed to them, (ii) how much of the CFC income should be attributed, (iii) when should the CFC income be

[130] Final Report op. cit. p. 57
[131] Final Report op. cit. p. 58

included in the tax returns of the taxpayers, (iv) how should the CFC income be treated and (v) what tax rate should apply to the CFC income.

Each of the following paragraphs will answer the questions respectively, starting by which taxpayers should the CFC income be attributed to them. Although the answer depends on each jurisdiction, most jurisdiction link it to the previous control criteria, where the already determined controller shareholder, for CFC ruled purposes, is the person of attribution. That also include minority shareholders, where the attribution would be proportionate to their control percentage. Based on this way, it is easier for jurisdiction and tax administrations and it reduces compliance burdens. Moreover, the income may be attributable to persons that are not the shareholders of the CFC, if they appear to have interest in the CFC. UK CFC rules, for instance, include 'option holders.[132] Nevertheless, some other jurisdictions, prefer not to link the attribution threshold to the minimum control threshold, and they would either set a lower or a higher attribution rate, depending on their policy objectives, than the minimum control threshold. The OECD, on their behalf, considers both ways as best practice.[133]

The amount of CFC income that should be attributed is calculated in all of the CFC jurisdictions in a proportion of each taxpayer's ownership. Still, jurisdictions may differ on the time of attribution, where some will attribute the CFC income based on the period of the ownership and others would attribute the entire portion of income based on the ownership of the last day of the year. Although both of them are considered best practices by the OECD, countries should design the rules to prevent any under-attribution of profits. Further, countries should bear in mind that the attribution percentage should not exceed 100 per cent of the income of the CFC. That may occur due to the overlap of the legal and economic control of the CFC.

Regarding when should the CFC income be included in the tax return of the taxpayer, several CFC jurisdictions specify the time by the end of the CFC's accounting period. Still, another choice which is implemented in the Korean CFC rules is that *"... the attributed income will be included on the return for the taxable year to which the 60th day from the end of the CFC's fiscal year belong.*".[134]

One more question is regarding how the CFC income should be treated in the parent jurisdiction. There are different approached inclined in different CFC rules for the treatment of the income. Some

[132] Gary R. R. B. L. Paisner LLP, 'UK' in, *Current Taxation of Host Country of income earned by Controlled Foreign Corporations,* (The Bureau of International Affairs, Inc 2012) p. 4-5
[133] Final report op. cit. p. 61-62
[134] Final Report op. cit. p. 63

jurisdiction would either take the approach of deemed dividends, which should be established on the existing dividend rules in the parent company or treat the income as it is earned directly by the taxpayer. Furthermore, some jurisdictions tend to treat the CFC income as earned directly by the parent shareholder. This approach is also known as piercing the corporate veil approach. However, the final report leaves it up to jurisdictions to choose the approach that suits their tax purposes.

Finally, regarding what is the tax rate that should apply to the CFC income? CFC rules in all jurisdictions tax the CFC income at the rate that the parent company would have applied. Besides the current practice, the final report provides a new approach to tax the CFC income based on a 'top-up tax'. This approach would rely on the minimum tax threshold that is already set by CFC rules and would tax the CFC income at the difference rate of the tax already paid by the CFC and the minimum tax threshold. For example, if the tax threshold is 25 per cent and the effective tax in the CFC jurisdiction is 15 per cent, the parent jurisdiction should subject the CFC income to the remaining 10 per cent. Nevertheless, the OECD is aware of BEPS concerns by applying the top-up tax, where taxpayers may be motivated to benefit from the lower taxation in the CFC jurisdiction, it mentions that such option may be appropriate to some jurisdiction and could be applied as a middle way for competitiveness concerns.[135]

3.7 Rules to prevent or eliminate double taxation:

It is the last building block and one of the fundamental policy objectives by the final report of the OECD. In order to provide rules that do not create obstacles to international commerce and economic development, they need to ensure that double taxation is prevented or avoided. There are several situations where double taxation may occur by the application of CFC legislation. However, the final report mentions three situations that double taxation may arise and provides solutions for each of the situations. All of the three final report situations and solution, in addition to further situations, are mentioned in Chapter 3, section 3.

It seems that the elimination of double taxation is of vital importance for the OECD. The final report tries to provide sufficient rules to prevent double taxation, and in several occasions indicates the significance of preserving the balance between the protection of the tax base of the CFC parent company and the elimination of double taxation of CFC rules to preserve competitiveness.

[135] Final report op. cit. p. 63-64

Furthermore, as a translation to the efforts of the OECD and its BEPS action projects jurisdictions are expected to transplant the work achieved to their national legislation with preserving their tax system policy. The European Union did not wait long to follow the work of the OECD and the initiative of tackling BEPS situations. That was reflected by the EU commission proposal 'Anti-Tax Avoidance' directive (ATAD).[136]

[136] Council Directive 'Proposal' (CNS) 2016/0011 on *Laying down rules against tax avoidance practices that directly affect the functioning of the internal market,* (COM 01.2016)

4. CFC rules and the EU ATA Directive.

The implementation of the OECD work, which is reflected in the final report for designing effective CFC rules, is a unilateral choice. That is, although not mandatory, promised to either strengthen the already existing CFC rules or help jurisdiction to design and introduce strong CFC rules. Assuming that different jurisdictions will follow the OECD action 3 recommendations is something good, but having several jurisdictions obliged to apply the rules is even better. Hence, the EU has realised the sever need of designing and implementing CFC rules and therefore inclined the rules in a directive on Anti-Tax Avoidance (Starting now, ATA directive).[137] Paragraph 1 of introductory remarks of the ATA directive refers to the initiative against base erosion and profit shifting and clearly indicates that "*In response to the need for fairer taxation, the commission, in its communication of 17 June 2015 sets out an action plan for fair and efficient corporate taxation in the European Union.*".[138] Accordingly, the ATA directive is aimed at a common implementation framework of the BEPS action plans with the goal of achieving a level playing field in the European Union.[139]

Harmonisation of tax rules and specifically CFC rules is unlikely to happen soon, and one set of international CFC standards are, realistically, cannot be achieved at the moment. The EU ATA directive, on the other hand, is a realistic and rational step to bring CFC rules of EU member states closer to each other. The EU ATA directive provides minimum requirements for member states to be implemented in their national law. Therefore, CFC rules and other rules, which are provided in the ATA directive, reflect the shared policy needs of the member states. The ATA directive provides minimum protection of the taxable base of member states, however, member states are free to go beyond the minimum standards provided and elect to implement a higher level of protection for their taxable base. Bearing in mind that the minimum standards provided in the ATA directive are legally binding for EU member states, even to member states that already have CFC rules.

In the following pages of this section, an explanation of the minimum requirements of the ATA directive regarding CFC rules will be provided. A limited comparison with the OECD recommendations, inclined in the final report, will serve as a base of analysis.

[137] Council Directive (EU) 2016/1164 on *Laying down rules against tax avoidance practices that directly affect the functioning of the internal market,* (ATA Directive July 2016) (Starting Now 'ATA Directive')

[138] Ibid. Para 1.

[139] P. Pistone, 'The Meaning of Tax Avoidance and Aggressive Tax Planning in European Union Tax Law: Some Thoughts in connection with the Reaction to Such Practices by the European Union' in, *Tax Avoidance Revisited in the EU BEPS Context,* (A.P. Dourado ed., IBFD 2017) p. 6

The ATA directive seems to be limiting the scope of CFC rules on several occasions. Primarily, by the introduction of the directive, it refers to the protection of, only, the parent company taxable base, by referring in paragraph 12 of the ATA directive that CFC rules "*have the effect of re-attributing the income of a low-taxed controlled subsidiary to its parent company.*".[140] Different from the OECD position which recommends for both the prevention of parent's company base stripping and foreign-to-foreign base stripping.

Furthermore, Article 1 of the ATA directive limits the scope of the directive, consequently CFC rules, to just those who are subject to corporate income tax in one or more of the EU member states. Limiting CFC rules to the taxpayers that are subject to corporate tax in a member state is, without a doubt, very controversial. Where such limitation will raise the concern of circumventing the rules, it is without a doubt a straightforward task for tax planning experts. Nevertheless, it has been mentioned from the beginning that the ATA directive is providing minimum standards and member states are free to go beyond the directive requirements.

4.1 Definition and Control:

By the reading of paragraph 12 and article 1 of the EU ATA directive, a CFC is an entity, including permanent establishment, located in a low tax jurisdiction and controlled by a resident shareholder. Article 7 paragraph 1(a)[141] set the control criteria, where an entity that a resident shareholder alone, or with 'its associated enterprises', holds more than 50 per cent of capital or more than 50 per cent of the voting rights or entitled to more than 50 per cent of the profit of the CFC. In addition, the directive Indicate in the introductory remarks that member states may which to reduce the control threshold. Moreover, the minimum standards of cumulative control target only the cumulative control of associated enterprises, similar to the OECD 'acting together' recommendation where several shareholders need to be acting together, to serve their interest, in the CFC to have their control level aggregated. The EU ATA directive incline three cumulative criteria for determining control, yet it is enough to consider that control prerequisite is fulfilled if only one of the criteria is met.[142]

[140] ATA Directive op. cit. para 12
[141] Ibid, Art. 7 para 1(a)
[142] Till Moser and Sven Hentschel, *The Provisions of the EU Anti-Tax Avoidance Directive Regarding Controlled Foreign Company Rules: A Critical Review Based on the Experience with the German CFC Legislation,* Intertax, Volume 45 (Kluwer Law International BV 2017) p. 610

4.2 Definition of Low Taxation:

Article 7 paragraph 1(b) of the EU ATA directive reads as following: "*the actual corporate tax paid on its profits by the entity or permanent establishment is lower than the difference between the corporate tax that would have been charged on the entity or permanent establishment under the applicable corporate tax system in the Member State of the taxpayer and the actual corporate tax paid on its profits by the entity or permanent establishment.*".[143] According to the wording of the article low taxation is determined if the CFC pays corporate income tax at 50 per cent lower than the tax that it would have paid in the parent company's jurisdiction. Furthermore, the article contains two main points. The first one indicates that the directive is targeting the actual or the effective tax paid by the CFC, not merely the statuary tax of the jurisdiction where the CFC is located. The second one can be concluded from the wording of the article 7 of the EU ATA directive. Where the reading of the article is not simple, and it is not clear whether there is a purpose of such sophisticated design of the article or it has no indications. However, due to the complexity of the article or, as other authors expressed, its 'poor drafting',[144] it is hard to determine the specific implications of Article 7.

4.3 Definition of CFC Income:

It has been said that due to the impossibility for EU member states to reach consensus for determining CFC income,[145] two approaches were provided in the directive, the 'categorical approach' and the 'transactional approach' respectively.

The EU ATA directive provides two alternatives for determining CFC income. Both are inclined in article 7.2. The first method, (a) targets specific categories that are more likely to harm the parent's jurisdiction tax base and are considered passive income. Categories are the following:

"(i) interest or any other income generated by financial assets;

(ii) royalties or any other income generated from intellectual property;

(iii) dividends and income from disposal of shares;

(iv) income from financial leasing;

[143] ATA Directive op. cit. Art. 7 para 1(b)
[144] P. Pistone, Tax Avoidance Revisited in the BEPS Context op. cit. p. 7
[145] Ricardo da P. Borges and Marta Carmo, 'The EU Directive against tax avoidance and its possible impact on the Portuguese Controlled Foreign Companies regime' in, *International Taxation: New Challenges,* (University of Minho 2017) p. 183

(v) income from insurance, banking and other financial activates;

(vi) income from invoicing companies that earn sales and services income from goods and services purchased from and sold to associated enterprises, and add no or little economic value;"[146]

Although the previous categories are determined to be CFC income, the ATA directive requires EU member state not to apply the referred points if the CFC is located in one of the EU member states and carries on a 'substantive economic activity'. Such sort of activities may be realised by 'relevant' facts and circumstances such as activity supported by staff, equipment, assets and or premises. Nevertheless, member states are kept free to apply point (a) of article 7.2, if the CFC is located in a third country that is not part of the 'EEA' Agreement. Such limitation indicates that the directive took into consideration the ECJ case law[147] and the rule mentioned above exist in order for the rules to comply with the Cadbury Schweppes[148] decision. Accordingly, if the CFC is located in one of the EU/EEA member states and does fall under point (a) of paragraph 2 of article 7 of the ATA directive, the member state of the CFC rules shall refrain of applying CFC rules.

Furthermore, the directive provides a second method inclined in Article 7.2 (b), where the tax base of the CFC shall include the "*non-distributed income of the entity or permanent establishment arising from non-genuine arrangements which have been put in place for the essential purpose of obtaining a tax advantage.*"[149] Here, EU member states are required to prove that the CFC is mainly established for the purpose of tax avoidance. However, this method could capture both passive and active income, yet still need to be proved that they are benefiting from a tax advantage. Provision (b) of paragraph 2 of article 7, the so-called 'Principal Purpose Test'[150], give a high margin of interpretation to member states. A supportive argument for inclining this provision in the ATA directive is that the design of the provision is aimed at providing countries which prefer a flexible and individual implementation of Article 7 and 8 of the EU ATA directive.[151]

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[146] ATA Directive op. cit. art.7 para 1(a)
[147] Till Moser op. cit. p. 613, and Borges op. cit. p. 185
[148] ECJ, 12 Sept. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd. V. Commissioners of Inland Revenue,* (2006), ECR I-7995.
[149] ATA Directive op. cit. Art. 7 para 2(b)
[150] Till Moser op. cit. p. 616
[151] Ibid, p. 617

4.4 Attribution and Taxation of CFC Income:

The EU ATA directive provides no rules on neither the attribution of the CFC income to the parent shareholders, nor provide rules on the taxation of the attributed income of the CFC.

4.5 CFC Exemption and CFC Income computation:

In addition to the 'substantive economic activity' exception which applies only to EU member states, which had been mentioned before. There are two exceptions provided in the EU ATA directive, one for each of point (a) and (b) of Article 7. Starting with the 'Passive Income' exception, which is inclined in paragraph 3 of Article 7.2. According to the directive, member states may opt not to treat (i) the entity or permanent establishment as a CFC if *"… one third or less of the income accruing to the entity or permanent establishment falls within the categories under point (a) of paragraph 2."*[152], or (ii), the financial undertakings as CFC if *"… one third or less of the entity's income from the categories under point (a) of paragraph 2 comes from transactions with the taxpayers or its associated enterprises."*[153]

An alternative exception is stipulated in paragraph 4 of article 7, regarding the principle purpose test. This rule enables member state, which opts to use point (b), not to treat the entity or the permanent establishment as a CFC if, (i) the accounting profits of the CFC are not more than EUR 750 000, and the non-trading income is no more than EUR 75 000. Or, (ii) if the CFC accounting profits do not exceed more than 10 per cent of its operating costs for the tax period.[154]

Furthermore, for computing CFC income, the directive also provides two rules for the calculation of CFC income. Paragraph 1 and 3 of Article 8 of the ATA directive stipulate that when applying point (a) of Article 7 paragraph 2, the income should be calculated according to the jurisdiction where the parent taxpayer is resident. Besides, the income included should be proportionate to the taxpayer's participation in the CFC.[155] On the other hand, when applying point (b) of Article 7 paragraph 2, *"… the income to be included in the tax base of the taxpayer shall be limited to amounts generated through assets and risks which are linked to significant people functions carried out by the controlling company. The attribution … shall be calculated in accordance with the arm's length principle."*[156]

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[152] ATA Directive op. cit. Art. 7 para 3 First Sentence
[153] Ibid, Second sentence
[154] Ibid, Art. 7 para 4
[155] Ibid, Art. 8 paras 1 and 3
[156] ATA Directive op. cit. Art. 8 para 2

However, in both situations of exceptions and computation, it is clear that the EU ATA directive is eager to provide EU member state with several options and alternative rules. That could also be seen by a clear indication that member states are free to apply, or not, the exception rules.

<u>**4.6 Rules to Prevent or Eliminate Double Taxation of CFC rules:**</u>

There are three rules provided in the EU ATA directive to eliminate situations of double taxation. The First rule inclined in Paragraph 7 of Article 8 requires member states, according to their national law, to allow tax credit through a deduction of the tax paid by the CFC from the tax liability of the resident taxpayer.[157] The second rule is regarding the actual distribution of profits by the CFC to its parent shareholders having them already taxed by the application of CFC rules. Here, according to paragraph 5 of Article 8, member states are required to avoid double taxation in such situations by allowing a deduction from the tax base of the parent taxpayer, if the income has been previously included in the taxable income of the taxpayer pursuant to article 7.[158] The third rule provided targets a specific situation of the treatment of the sale or the disposed shares of the CFC. Here, shareholders' profits derived from the disposition of the shares, or of the business carried out by, of the CFC that has already been included in the CFC income based on Article 7, shall be deducted from the taxable base of the taxpayer.[159]

However, CFC rules in the EU ATA directive do not include any rules requiring member states t relief tax that have been paid by the CFC in the CFC country, nor relief taxes paid by intermediate CFCs.[160] Nevertheless, it is mentioned, in the introductory remarks of the EU ATA directive, that taxpayers should be relieved from double taxation when such double taxation is a result of the application of the rules of the EU ATA directive. The Directive explicitly states *"... the rules should not only aim to counter tax avoidance practices but also avoid creating other obstacles to the market, such as double taxation.*"[161]

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[157] ATA Directive op. cit. Art. 8 para 7
[158] Ibid, Art. 8 para 5
[159] Ibid, Art. 8 para 6
[160] Peter K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – An Interim Nordic Assessment*, (De Gruyter Open 2016) p. 101
[161] ATA Directive op. cit. Introductory remarks para. 5

Chapter (iii) CFC legislation and Double Taxation

1. The Elimination of International Double Taxation.

Before turning to double taxation situations of CFC rules, it is essential to understand what is meant by international double taxation and what are the tools for eliminating double taxation. International tax law may not exist in one code or set of rules, however, it is embodied in a web of network of thousands of bilateral treaties.

Tax systems differ from one state to another, and each state develops its tax system in the way that serves its public policy and adapts its tax rules to achieve the goal of their fiscal policy, which is one of the main reasons why tax rules differ in different jurisdictions. The cohabitation of tax systems leads to variations in tax rules which may give rise to double taxation or even double non-taxation on the both the national and international level. International double taxation could be occurred in different stages and due to various reasons. Generally, jurisdictions levy taxes based on one of the two well-known jurisdictional bases, the source or the residence principles.[162] According to residence-basis taxation principle taxes are imposed based on the residence of the taxpayer. However, residence is defined by domestic rules of each jurisdiction. Mainly, residence determination may be based on the time spent in a jurisdiction or the personal connection to a jurisdiction. Moreover, in source-basis taxation principle the tax is imposed based on the source of income, if it is arising or derived from a source in that jurisdiction. In addition, the citizenship of a particular jurisdiction could be linked to the residence of a taxpayer and therefore could serve as basis of tax, for instance, US citizenship.

The variations of tax claims between jurisdictions could result in taxpayers suffering international double taxation (Starting now 'Double Taxation'). Taxpayers may suffer from double, or more, taxation in situations where we have more than one residence or one source of income. Double taxation could arise in different situations and due to several reasons. For instance, if an income of a taxpayer is derived from a jurisdiction different from the jurisdiction he or she is residing, and one jurisdiction taxes income based on the residence of the taxpayer and the other jurisdiction taxes the income based on the source of income of the taxpayer. It may also occur when a person is considered a resident of two states due to the asymmetrical definition[163] of residence in the domestic rules of the respective states. It could also

[162] H. David Rosenblum, *From the Bottom Up: Taxing the Income of Foreign Controlled Corporations,* Volume 26, Issue 4 (Brooklyn Journal of International Law 2001) p. 1533

[163] M. Helinen, A. J. M. Jimenez and IFA, *The notion of tax and the elimination of international double taxation and double non-taxation*, Cahiers de droit fiscal international, vol. 101B (IFA 2016) p. 67

occur when the taxpayer is a resident in one state and a holder of the citizenship of another state which taxes income based on citizenship (United States).

Moreover, states levy tax based on either worldwide or territorial bases. A state with a worldwide taxes system tax the income of a resident company on their worldwide income regardless of the origin of the income. Both income from sources inside and outside the state are subject to tax. A worldwide tax system extends the tax liability to income that is outside the territorial borders of the state. And non-resident companies in a worldwide system pay taxes on income derived from sources within the territory of the taxing state. On the other hand, territorial tax system taxes only the income, of resident and non-resident companies, which is derived from within the territorial borders of that state. Source taxation is recognised, according to international custom, as the primary right to tax.[164] As a result of the overlap between a worldwide and territorial tax systems double taxation may occur. A taxpayer could be subject to tax on the same income under different jurisdictions implementing different systems.

Double taxation is a natural result of the variety of the principles implemented in different legal systems. The issue of double taxation is not a new one, it was already highlighted by the League of Nations in 1920[165]. The adverse effects of double taxation on global growth were witnessed before, and members of the League of Nation realised that the consequences of international double taxation would be harmful for the members' economies and international trade. All members of the league were sharing the need to eliminate such issue and work on enacting international rules to eliminate double taxation. International rules that are clear, predictable and could pave the way to govern both governments and businesses. Hence, thousands of bilateral treaties were drafted and international cooperation between countries aimed at the prevention of double taxation. The shared need for such rules served as a base for the adoption of common standards to eliminate double taxation. Such common standards were the pillars of bilateral treaties between member states of the league, intending to achieve similar results generally.[166]

The OECD -introduced in paragraph 2.1 of this chapter - highlighted the negative impact of double taxation on international economic relations as the commentary stated:

"... Its harmful effects on the exchange of goods and services and movement of capital, technology and persons are so well known that is scarcely necessary to stress the importance of removing

[164] B. J. Arnold, *International Tax Prime,* Third Edition (Kluwer Law International BV 2016) p. 22
[165] OECD, *Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan),* (Paris 2013) p. 7
[166] Ibid. p. 9-10

the obstacles that double taxation presents to the development of economic relations between countries"[167]

International double taxation is relieved using the exemption method, the credit method and/or the deduction method. However, the methods maybe used interchangeably. Relief methods are applied either unilaterally or under tax conventions. However, it is more common to use the exemption and credit methods since the deduction method proved to have a low impact on eliminating double taxation. The exemption method would exempt foreign sourced income from domestic taxation, where the credit method would credit the foreign tax paid, on the foreign source income, against the domestic tax.[168]

Unilateral and bilateral measures are used to facilitate trade between countries and remove situations of double taxation. Therefore, tax treaties are designed to eliminate double taxation and remove obstacles of international economic relations that have not been tackled unilaterally. It is widely accepted that the efforts to eliminate international double taxation preserve countries' right to tax. Tax treaties are the inter-national tool where taxation rights are distributed between the contracting states of a tax treaty. This allocation or distribution provides taxpayers with more legal certainty about the extent of their tax liability. Double taxation is not forbidden in customary international law[169] as long as it results from the interaction of domestic laws that are in line with international standards. However, International law attempt to reduce predicted situations of double taxations by introducing rules that establish an order to which states must withdraw their tax claims.

International tax law or systems existence has been denied and called imaginary[170], and general international law does not contain rules for the elimination of double taxation. Therefore, rules are enacted in bilateral treaties,[171] and the web network of international tax treaties maybe be referred and international tax law. Such bilateral treaties are called 'Double Tax Conventions', which reflect an agreement signed and concluded by two states in order to overcome issues of double taxation. Tax treaties are either based on the OECD or UN models, however, some countries elect to develop their own models such as the U.S and the Netherlands.[172] Nevertheless, over time tax treaties have been fairly converged and influenced by

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[167] OECD - 2017, *Model Tax Convention on Income and on Capital*, (Paris 2017) (Starting now 'OECD Model 2017') Para. 1

[168] Gloria Teixeira and David Williams, *The Impact of Unilateral Tax Credit in the US, UK and Other Tax Systems,* 23 INTERTAX, issue 11 (Kluwer Law International 1995) p. 573

[169] Alexander Rust, 'Double Taxation' in Alexander Rust, *Double Taxation within the European Union,* (Kluwer Law International BV 2011) p. 3

[170] Reuven S. Avi-Yonah, *International Tax as International Law an Analysis of International Tax Regimes,* Cambridge Tax Law Series, (Cambridge University Press 2007) p. 3

[171] Ekkehart Reimer and Alexander Rust, *Klaus Vogel on Double Taxation Conventions*, (Kluwer Law International BV, 4th rev. ed 2015) Note 11.

[172] Gloria Teixeira, Double taxation treaties: towards multilateral convention, in João Sérgio Ribeiro, *International Taxation: New Challenges,* (University of Minho-School of Law 2017) p. 151

each other, with the U.S model being heavily influential due the significant presence of the U.S in the global markets.[173]

[173] Allison Christians, *BEPS and the New International Tax Order,* BYU L. Rev. (2016) p. 1615

2. Economic Versus Juridical Double Taxation

Double taxation is divided into two categories, 'Economic' and 'Juridical' double taxation. International juridical double taxation or 'legal'[174] double taxation (Starting now 'Juridical Double Taxation') could be defined in general as "*the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods*.".[175] In other words, it happens when one taxpayer is subject to two, or more, identical or similar tax liabilities on the same stream of income. On the other hand, international economic double taxation (Starting now 'Economic Double Taxation') is "*where two different persons are taxable in respect of the same income or capital*".[176]

Juridical double taxation occurs when the same person is taxed twice, or more on the same income by two, or more states and it is identified by the OECD commentary on double tax conventions. The OECD Model Convention commentary mentions situations where juridical double taxation may arise, and it is stated in the three following instances:

(i) Where the same person is subject to tax in two, or more, states on his or her worldwide income or capital (so-called a residence-residence conflict).

(ii) When a person is a resident of state A and derives income or capital from state B and both states impose taxes on that income or capital (so-called residence-source conflict).

(iii) When a person is neither a resident of state A nor B but derives or deemed to be deriving income or owns capital in the respected states and the same income or capital is subject to tax in both states (so-called source-source conflict). It occurs for example when a person has a Permanent Establishment in state A through which he derives income of state B.[177]

The juridical or legal definition of double taxation is distinguished of the economic definition. Juridical double taxation arises specifically due to a 'jurisdictional' conflict in applying the rules, such as a conflict in the determination of the residence or the source.[178]

Economic double taxation, on the other hand, happens when the same income is subject to tax in the hands of two different taxpayers. On the international level, economic double taxation deals with two different taxpayers residing in different jurisdictions.[179] Economic double taxation may arise in different

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174 B. J. Arnold, *International Tax Prime,* Third Edition (Kluwer Law International BV 2016) p.45
175 OECD Model 2017 op. cit. Commentary Introduction Para. 1 and Commentary to Article 23 A and B Para. 1.
176 ibid, Commentary to Article 23 A and B Para. 2.
177 ibid, Para. 3.
178 A. Miller and L. Oats, *Principles of International Taxation,* Fifth Edition (Bloomsbury Professional Ltd 2016) p. 98
179 O. Remacle and S. Nonnednkamp, 'Economic Double Taxation as an Obstacle to Cross-Border Investment' in Alexander Rust op. cit. p. 20

scenarios. Standard economic double taxation occurs when corporate profits are taxed at the company's level and later, when dividends are distributed, on the level of the shareholders. This type of economic double taxation is a result of the legal separation principle that treats, for the purpose of tax law, companies as separate legal entities of their shareholders. This legal separation results in two-tiered of taxing systems and therefore gives the right to the taxing authority to tax both the corporate income in the first stage and then taxes the same income on the level of shareholders in the second stage. Standard economic double taxation is usually mitigated by inclining national provisions to eliminate such double taxation instances.

Other situations of economic double taxation may arise, for instance, if the income's attribution rules are different from one state to another, having the income attributed to different persons. For example, one jurisdiction's rules attribute income to the legal owner of the assets of an entity, where the other jurisdiction's rules attribute the income to the person who is in possession of economic control of the assets.[180] Also, economic double taxation may occur in the case of transfer pricing adjustments. Double taxation in transfer pricing adjustments may arise when a resident's jurisdiction calculates the foreign taxable income of the taxpayer and increases it because it considers that the company paid too high price (or charged too low price) in transactions with related parties located outside the resident's jurisdiction.[181] It also could be occurred by the application of CFC rules (explained later in 3.1).

International double taxation in its different forms may be solved by, first, domestic measures that each country include in their domestic tax rules preventing or eliminating double taxation. Domestic rules, in many cases, are very efficient for the purpose of tackling double taxation. However, in many other situations, there is a need for international rules which are embodied in tax treaties. The OECD has concluded, in a statement, which first appeared in the 1992 OECD Model Convention,[182] that international double taxation is a matter which is solved in many instances by the domestic law and by tax treaties in many others[183]. The interaction between the domestic law and tax treaties regarding the rules of elimination of double taxation are so far the most appropriate solution for complete elimination of double taxation.

[180] Ekkehart Reimer and Alexander Rust op. cit. Note 4.
[181] Raffaele Russo, *Fundamentals of International Tax Planning*, (IBFD 2007) p. 8-9.
[182] OECD, *Model Tax Convention on Income and on Capital*, (Paris 1992) Para 3.
[183] Juan Becerra, *Interpretation and Application of Tax Treaties in North America*, (IBFD 2007) p. 42.

2.1 OECD/BEPS Position of Economic Double Taxation

It was as long as the 1920s when international double taxation was declared[184] as an obstacle for investment abroad and a barrier to the circulation of capital around the world by the League of Nations in a conference held in Brussels September 24th, 1920.[185] Since then, international double taxation was addressed by the League of Nations and its successor United Nations together with the Organization for European Economic Co-operation OEEC and its successor the Organization for Economic Co-operation and Development OECD.[186]

The OECD released the first draft of the Model Tax Convention (Starting Now 'OECD MC) in 1963[187] which reflected all of the previous immense work that started by the League of Nations and later by the OEEC.[188] All the work that had been carried out previously was subject to the revision by the Fiscal Committee, and after the Committee of Fiscal Affairs, of the OECD and resulted in the introduction and the publication of the 1977 Model Convention.[189] Model conventions of the OECD had indeed played a tremendous job in the harmonisation of international tax rules for the elimination of double taxation which are enacted in tax treaties. The work of the OECD and its predecessor the OEEC, together with the previous work of the League of Nations and the bilateral treaties between countries at that time has contributed to the development of tax treaties.

The OECD member countries tend to draft their tax treaties following the OECD Model Convention, and they are all committed to the objective of enhancing international trade and the development of International Commerce. Article 1 of the OECD convention states:

The OECD member states commit "*to achieve the highest sustainable economic growth and employment and a rising standard of living in member countries, while maintaining financial stability, and thus to contribute to the development of the world economy*"[190] Also, members of the OECD commit to "*pursue their efforts to reduce or abolish obstacles to the exchange of good and services and current payments and maintain and extend the liberalisation of capital movements*".[191]

[184] Juan Becerra, *Interpretation and Application of Tax Treaties in North America,* (Online Books IBFD 2013) p. 4
[185] League of Nations timetable at <http://worldatwar.net/timeline/other/league18-46.html>
[186] Juan Becerra op. cit. p. 9
[187] OECD, available at <https://bit.ly/2YxbLkX>
[188] Starting from the very first Double Tax Treaty between Austria-Hungary and Prussia and the various reports of the fiscal committee of the League of Nations, in addition to the 1943 Mexico Model and 1946 London Model, to the reports of the Fiscal Committee of the OEEC.
[189] OECD Model 2017 op. cit. Introduction, Para. 7
[190] OECD*, Convention on the Organization for Economic Co-operation and Development,* (Paris 1960) Art. 1(a)
[191] Ibid, Art. 2(d)

Therefore, to reach the purpose of the OECD Model states must work together on the elimination of double taxation. The OECD Model Tax Convention in addition to the Commentary thereto was updated 10 times, in 1992, 1994, 1995, 1997, 2000, 2003, 2005, 2008, 2010, 2014 and most recently 2017. The updates of the Model Conventions and its Commentaries have undeniably contributed to the development of international tax law.

The text of the OECD model convention does not mention, state or suggest that the rules of elimination of double taxation should apply only to juridical double taxation, nor it mentions the diversion of concepts between juridical and economic double taxation. That is, however, contrary to the commentary of the OECD model convention. The OECD commentary is clear about the context of the rules of eliminating double taxation. In the first paragraph of the commentary, it mentions the definition of juridical double taxation which indicates to, first, the separation of the two concepts of double taxation and, second, to the purpose of the model convention.

Paragraph 1 of the commentary introduction stipulates: "*International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on .... are so well know that is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relation between countries*."[192]

Moreover, paragraph 3 of the commentary continues to assure that the OECD member states are keen to remove obstacles of such double taxation. "*These are the main purposes of the OECD Model Tax Convention on Income and on Capital, which provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation*."[193]

The wording of the commentary of the OECD emphasises on the elimination of double taxation. Thus, the avoidance of double taxation is clearly in context with the OECD model tax conventions. Nevertheless, tax treaties do not attempt to avoid double taxation in general, but only in accordance with their scope.[194] However, the so-called 'economic double taxation', as stated in the commentary several times, is mentioned in different parts of the commentary.[195] The commentary frequently indicates that the

[192] OECD Model 2017 op. cit. Introduction, Para. 1
[193] Ibid. Para. 3
[194] Michael Lang, *The Application of the OECD Model Tax Convention on Partnerships; A critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs,* (Kluwer Law International 2000) p. 29.
[195] Indications to articles where the OECD commentary touches upon the concept of economic double taxation. OECD – Introduction para 15.3, Art. 9 Paras. 5, 6.1, and 10, Art.10 paras 40, 41 and 42, Art.23 A and B paras 2, 68, Art. 25 Paras. 10,11 and 12.

elimination of economic double taxation should be left to the domestic legislation. Additionally, the Commentary of the OECD indicates that the concept of economic double taxation is ill-defined and less precise in contrast to the notion of juridical double taxation, and it recommends studying the issue from an economic perspective.

Paragraph 41 of the OECD MC of the commentary on Art. 10 says:

"... *as the concept of economic double taxation was not sufficiently well defined to serve as a basis for the analysis, it seemed appropriate to study the problem from a more general economic standpoint...*"[196]

Likewise, it is pointed out in the preliminary remarks of article 23 A and B of the OECD commentary, concerning the methods for eliminating double taxation, that the wording of the article applies only on juridical double taxation. Moreover, it explicitly states that economic double taxation should be disregarded in the context of this article and must be dealt with, if the parties wish, in a separated bilateral treaty negotiation:

"*This case has to be distinguished especially from the so-called economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two states wish to solve problems of economic double taxation, they must do so in bilateral negotiations*"[197]

Moreover, the OECD commentary states that the concept of economic double taxation is not yet accepted by some state, where some other states do not recognise the necessity to eliminate or prevent economic double taxation at the international level.

Nevertheless, the OECD throughout the commentary indicates that economic double taxation should be eliminated or prevented in two different instances. First, in the partnership situation and second, situation of transfer pricing. Here, the commentary obliges states to resolve issues of economic double taxation which are a result of different qualifications of partnerships in the state of the partner and the state of partnerships. That is incorporated in article 23 A and B of the commentary; however, this incorporation comes as a result of the 1999 OECD report on 'The Application of OECD Model Tax Convention to Partnerships'.[198] Double taxation in the context of partnerships occurs when the state of the

[196] OECD Model 2017 op. cit. Commentary Art. 10 Para. 41
[197] OECD Model 2017 op. cit. Commentary Art. 23 A and B. para. 2.
[198] OECD, *The Application of OECD Model Tax Convention to Partnerships,* (OECD 1999) p. 42

partnership elects it to be a company where the state of the partner treats the partnership as a transparent entity.

Paragraph 96.2 of the OECD commentary on article 23 A and B states:

"... *whether the State of residence of the partner, which taxes the partner on his share in the partnership's income, is obliged, under the Convention, to give credit for the tax that is levied on the partnership in the State of the partnership, which that latter State treats as a separate taxable entity. The Answer to that question must be affirmative* ..."[199].

Economic double taxation is also mentioned in the context of transfer pricing and the commentary indicates that the competent authorities should consult each other, not just on cases of juridical double taxation but also economic double taxation:

Paragraph 10 of the OECD MC commentary on Article 25:

"*Article 25 also provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation*, ..." [200]

It seems from the reading of different parts of the commentary that economic double taxation is not as harmful on international commerce as juridical double taxation and therefore the OECD MCs are not aimed at solving economic double taxation unless in the specific situations mentioned above.[201]

The position of the OECD on economic double taxation is clear and stated in various parts of the commentary. The clear indication that the OECD Model Tax Convention is limited in application to cases of juridical double taxation is affirmed both explicitly and implicitly. Moreover, the two different occasions where the commentary dealt with economic double taxation, the elimination of such double taxation was limited and cautiously stated.

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[199] OECD Model 2017 op. cit. Commentary Art. 23 A and B para 69.2

[200] OECD Model 2017 op. cit. Commentary to Art. 25 para. 10

[201] This view is mentioned in both Blazej Kuzniacki, *The Need to Avoid Economic Double Taxation Triggered by CFC Rules under Tax Treaties, and the Way to Achieve It,* INTERTAX, Vol. 43, Issue 12 (Kluwer Law International BV 2015) p. 759 and Michael Lang, *The Application of the OECD Model Tax Convention on Partnerships; A critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs,* (Kluwer Law International 2000) p. 29

3. Double Taxation in the context of CFC Rules

Although, CFC rules are enacted to counteract tax avoidance and to tackle BEPS activities. CFC legislation may have significant implications on MNEs and global businesses and could create obstacles for international trade. Such obstacles are translated by the risk of double taxation which results of the application of CFC legislation. Double taxation by the application of CFC rules may arise due to various reasons, and it occurs in different forms. In general terms, CFC rules tax income of a non-resident foreign company having this company controlled by a resident of the CFC rules' jurisdiction. The tax imposed may target an income of a CFC that have been already taxed before in the residence country of the CFC. Controlled foreign companies that are subject to CFC rules are usually located in a low or no-tax jurisdiction. Nevertheless, a CFC that suffers from taxation of CFC rules may be taxed on the same income in the CFC jurisdiction.

Double taxation of CFC rules, mainly, represents economic double taxation, where we have the same stream of income taxed more than once at the level of two different taxpayers. However, CFC rules usually contain relief provisions to prevent or eliminate double taxation occurred by their application. Some Jurisdictions would exempt dividends of from tax if they were already subject to tax under CFC rules or will give credits against foreign taxes paid by the CFC in the country where it is located. Hence, we are going to evaluate the efficiency of double taxation relief of CFC rules. The evaluation will cover the situations that are presented by the final report, in addition to other situation indicated by country practice.

Concerns of CFC rules' double taxation were highlighted in several comments mentioned in the public the discussion draft of BEPS action 3,[202] where several respondents shared their concerns about situations of double taxation that could occur as a result of the application CFC rules and expressed their views on the obstacles that companies may face in this regard. The final report by the OECD advised that states should apply their CFC legislation in a way that does not lead to double taxation.[203] Additionally, the final report provides some rules to prevent and eliminate double taxation which are considered best practice measures that should be implemented in domestic CFC legislation.

[202] OECD, *Public Discussion Draft BEPS Action 3: Strengthening CFC rules*, (2015) <http://www.oecd.org/tax/beps/public-comments-beps-action-3-strengthening-cfc-rules.htm>

[203] Final Report 2015 op. cit. p. 65.

Although these recommendations are best practice, local authorities are not obliged to follow such approach, and even if they do follow the recommendations of the OECD, concerns over double taxation are still relevant and may exist.

3.1 Situations where Double Taxation of CFC rules Could Arise and measures to eliminate it:

As mentioned previously in this dissertation, CFC legislation include some mechanisms that are designed to eliminate double taxation. The majority of countries that have CFC rules tend to incline relief provisions to limit the risk of double taxation. In addition to that, the final report of the OECD provides three solutions to solve the three different situations that it addresses in the report. The final report addresses three different situations where double taxation could be occurred by the application of CFC rules. Besides, the report provides what is referred to as best practice rules that would prevent or eliminate double taxation.

"*There are at least three situations where double taxation may arise: (i) situations where the attributed CFC income is also subject to foreign corporate taxes; (ii) situations where CFC rules in more than one jurisdiction apply to the same CFC income; (iii) situations where a CFC actually distributes dividends out of income that has already been attributed to its resident shareholders under CFC rules or a resident shareholder disposes of the shares in the CFC*"[204]

It is also acknowledged by the final report that there could be more situations where double taxations may occur, and it mentions the case of transfer pricing when two states adjust the transfer pricing and "a CFC charge arises in a third jurisdiction."[205] The final report is clear about the existence of other situations of double taxation, and in several parts of the report, the OECD recommends that countries should incline domestic measures to limit the possibilities of double taxation. However, the final report discusses, only, three main situations and provides what is best practice to avoid them. All of the recommendations are not mandatory as the final report has, in general, a soft law feature and does not oblige countries to follow the rules but provide guidance to the best practice that countries may uphold to enhance their CFC legislation.

[204] Final Report 2015 op. cit. p. 65
[205] Ibid, p. 65,68

3.1.1 Situations with Foreign Taxation of the CFC:

The very first double taxation instance could occur if the CFC is subject to tax in the CFC jurisdiction. CFC rules may subject to tax the income of a CFC that have been already taxed by the residence jurisdiction of the CFC. The OECD recommends that CFC rules provide indirect foreign tax credit which credits the tax paid by the CFC.[206] The tax credit should target, according to the final report, the effective tax paid by the CFC in the CFC jurisdiction, and it also may include withholding taxes. For instance, French CFC rules provide a credit against French tax in respect of foreign taxes paid by the CFC in its jurisdiction that are the same or similar to the French corporate taxes.[207] Likewise, Italian CFC legislation gives credit for the taxes paid by the CFC against the tax charged under domestic CFC legislation.[208] The US legislation states that a US shareholder is entitled to foreign tax credit requiring that the shareholder owns directly 10% of the voting stock of the CFC.[209]

3.1.2 Situations with CFC Taxation in Multiple Jurisdictions:

Double, or more, taxation may arise if the CFC is taxed under CFC legislation of multiple jurisdictions. That may happen if the CFC is directly held by an intermediary entity and indirectly held by a resident shareholder. An example to simplify this situation will be the following: Parent Co is located in country A and holds directly Subsidiary 1 in country B which in itself holds directly Subsidiary 2 located in country C. Subsidiary 2 qualifies as a CFC with indirect control under country A CFC rules, and also qualifies as a CFC with direct control under country B CFC rules. In this example we have double taxation concern if both countries A and B apply their CFC rules on Subsidiary 2, it could raise triple taxation if Subsidiary 2 is also subject to tax under country C tax rules.

For situations as mentioned earlier, the OECD also recommends allowing foreign credits for all taxes paid by the CFC.[210] In our example, the final reports piece of advice is that country A provides foreign tax credits for taxes paid in country C and also country B. Moreover, the OECD indicates that there should be a hierarchy of CFC rules applied. The final report recommends the existence of a hierarchy rule in the application of CFC legislation, but it does not give much explanation about the rule. However, the report

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[206] Final Report op. cit. p. 66

[207] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, *The taxation of foreign passive income of group of companies,* Vol. 98 A (IFA 2013) p. 312.

[208] Michael Lang, H. Aigner, U. Scheuerle and M. Stefaner, *CFC Legislation, Tax Treaties and EC Law,* (Kluwer Law International B.V. 2004) P. 361

[209] Ibid, p. 40.

[210] Final Report op. cit. p. 66-67

reflects the OECD perspective of giving the right of the application of the CFC legislation to the jurisdiction closer to the CFC.

3.1.3 Situations of Dividend Distributions and Capital Gains:

In this section, there are two situations that the final report points out, (i) the actual distribution of dividends of an already attributed and taxed CFC income under the parent company CFC rules, and, (ii) the treatment of gains derived from the disposition of shares of the already taxed CFC. For the first point, such issue is solved if the parent jurisdiction would have a participation exemption and apply it to the dividends in question. However, in case of the absence of such participation exemption rule or the participation exemption does not apply to the dividends in question, CFC legislation is advised to incline relief provision that exempt CFC dividends from tax, having them already taxed under CFC rules of the parent jurisdiction. Such relief should also include withholding taxes applied in the country of the CFC. One more issue may arise in the first point, where difficulties may exist in determining that the distributed dividends are coming out from the already attributed CFC income. This issue may be more complicated if there is an intermediary entity. Here, countries may tend to assume that the distributed dividend is out of the already attributed income and may limit the dividends exemption to the amount taxed under the CFC rules in the relevant tax year.[211]

For example, income, in the form of dividends, effectively distributed by the CFC to its French parent company is not subject to tax if the parent company was previously subject to tax on the income of its subsidiary under CFC legislation.[212] Likewise, Italian domestic rules grant tax relief for dividends of the already attributed and taxed CFC income.[213]

The second situation which may raise the issue of double taxation, if the shareholder taxpayer of the CFC realises gains from the disposition or sale of the shares of the CFC. Although the final report mentions that countries may also relief gains from CFC rule taxation, to the extent that the same amount has been previously subject to tax under the CFC rules. However, it clearly states that countries which do not exempt gains on disposition are not obliged to change their rules to comply with the

[211] Final Report op. cit. p. 68

[212] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, *The taxation of foreign passive income of group of companies,* Vol. 98 A (IFA 2013) p.312.

[213] Michael Lang, H. Aigner, U. Scheuerle and M. Stefaner, *CFC Legislation, Tax Treaties and EC Law,* (Kluwer Law International B.V. 2004) P. 361

recommendations.[214] Nordic regimes such as Finnish CFC rules, Norway CFC rules and Sweden CFC rules appear to exempt gains on the disposition of CFC shares from tax in order to avoid double taxation.[215]

3.1.4 Other Situations:

The OECD clearly indicates that other instances of double taxation may be present and the final report give an example of the interaction of CFC rules and Transfer Pricing rules.[216] In addition, countries may need to check if their relief provisions are sufficient enough to eliminate other situations of double taxation by the application of CFC rules, including the transfer pricing situations. The OECD is aware of the risks that CFC rules may pose on double taxation and in reality, there are several instances where double taxation may arise because of CFC rules. Besides the situations that were mentioned in the final report, the risk of double taxation could arise in other situations. It is significant for the purpose of this work to discuss some of the situations that were not mentioned by the final report but still pose a high risk of double taxation.

Double taxation of CFC rules may arise due to several reasons and in different forms, the following situation will explain how this double taxation could occur.

For instance;

(i) The interaction of CFC rules with thin capitalisation rules, or with other anti-abuse rules, may lead to double taxation. That may happen when the CFC income is taxed in the CFC parent's jurisdiction, but the corresponding expenses are non-deductible in the country of the taxpayer due to thin-cap rules[217].

(ii) Also, the interaction of CFC rules with dividends add-back rules, where the dividends would be deemed to be added back to the distributing company for not fulfilling certain criteria. Such rules operate in the French tax system and may raise the issue of double taxation.[218]

(iii) Other situations may occur based on the credit method's scope in relief situations. For example, in Germany[219], the attributed CFC income is subject to both corporate income tax and trade tax, and the relief method in Germany only allows for credits against CIT.

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[214] Final Report op. cit. p. 68

[215] Peter K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – An Interim, (De Gruyter Open 2016) p. 101*

[216] Final Report op. cit. p. 68-69

[217] OECD, *Public Discussion Draft BEPS Action 3: Strengthening CFC rules*, (2015) p. 68,114

[218] Ibid, p. 114

[219] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, *The taxation of foreign passive income of group of companies,* Vol. 98 A (IFA 2013) p. 337

(iv) Double taxation of CFC rules may occur in cases of 'dual residence', where company may be treated as a resident company in two different states. That may occur if a company meets the residence criteria in two different jurisdictions. Accordingly, each jurisdiction could subject the same company to CFC rules considering it a resident company.[220]

(v) Double taxation is also present due to timing mismatches between the attribution date of the CFC income and the actual payment of tax by the CFC on the attributed income. For example, if the CFC legislation attributes the CFC income to its parent company by the end of the fiscal year and the CFC paid no tax at the time of the attribution but, later to that date, paid tax on the income that has been already attributed to the parent company and taxed under CFC rules. German CFC rules, for example, only realise foreign taxes for the credit or deduction method if the taxes have been actually paid by the CFC in the moment of the attribution of the CFC income.[221] However, such situations may be mitigated by the application of credit method including a carry-forward rule for an excess foreign tax credit.

Double taxation of CFC rules may occur in several other situations, and future implementation of CFC rules will also raise new issues of double taxation. Concerns over double taxation will always be present in the absence of clear and unified rules, and despite the similarity of the purpose of CFC rules, they are not, at all, harmonised. CFC rules have different features in different jurisdiction, and it could range from different scope of application, various control or tax threshold rates to several other variations. The OECD recommendations are not very far from this reality, and they provide multiple versions of CFC rules. That alone may raise concerns of double taxation even with the existence of domestic measures for the prevention or elimination of double taxation.

3.2 CFC Rules and Tax Incentives:

CFC rules are aimed at taxing non-resident foreign corporations that are controlled by a resident shareholder. The design of the rules may vary from one jurisdiction to another as we have seen previously. Still, a common feature of CFC legislation that may be shared between different CFC rules in different jurisdictions is that the CFC, which is subject to CFC rules taxation, is located in a low tax jurisdiction including those with zero tax rates. However, countries define low-tax based on their domestic rules. A corporation incorporated in a low tax jurisdiction controlled by a resident shareholder may have the aim of avoiding the tax of the parent's jurisdiction, however, that is not always the case. A CFC may be located

[220] Gilles V. Hulles, *Current Challenges for EU Controlled Foreign Company Rules,* Bulletin for International Taxation (IBFD 2017) p. 721
[221] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, *The taxation of foreign passive income of group of companies,* Vol. 98 A (IFA 2013) p. 82

in a country with a comparable tax rate to the parent jurisdiction's tax rate, but the CFC jurisdiction provides tax incentives to attract foreign investments. The following scenario makes it simpler to have a better understanding of the situation. Country C has a tax rate of 30 percent as its corporate income tax and provides a tax incentive in the form of 3 years tax-holiday where CIT will be 0 percent. Country A taxes resident's entities at a rate of 40 percent under its corporate income tax. We have Parent Co resident in country A holds all the share of Subsidiary CO in country C and based on country's A CFC legislation subsidiary CO is treated as a CFC. CFC legislation of Country A provides a relief for foreign taxes paid by the CFC. Nevertheless, no CFC legislation provide relief for both foreign taxes paid and payable of a CFC.

The issue mentioned is the previous scenario is very common considering developing countries. Tax incentives are always a tool to attract foreign investments and developing countries usually make use of this element. The issue of tax incentives and CFC legislation is present, for example, in Portugal where tax incentives are provided to Portuguese groups of companies by the Portuguese-speaking African countries to attract local investments to their countries.[222]

The issue of tax incentives and CFC rules raise two questions. One is related to the extent whether CFC rules should relief taxes paid or/and payable by the CFC. The second question is related to double tax conventions with a tax-spearing provision. The first question is to be answered in Chapter (v) 2.1. However, and in order to answer the second question we need first to understand the relation between CFC legislation and Double tax treaties.

[222] M. Dahlberg and B. Wiman, Cahiers de Droit Fiscal International, *The taxation of foreign passive income of group of companies,* Vol. 98 A (IFA 2013) p. 613

4. CFC Rules and Tax Treaties:

In order to see if CFC rules could benefit from tax treaties, we need first to examine, first, if the rules are compatible with tax treaties and what are the main arguments about the issue. The compatibility of CFC rules with tax treaties is debated a lot, despite the fact that many countries have or going to introduce CFC rules. The interaction of CFC rules and tax treaties have been already discussed extensively in literature and was a controversial issue among tax scholars.[223] Therefore, the issue of CFC rules and treaty override is not a new one. Once again, the various forms of CFC legislation around the world and the complexity of the rules make it hard to analyse the consequences of the application of the rules. Tax legislations in general and CFC rules in specific are very complex and vary from one jurisdiction to another. Therefore, domestic rules are also different even in countries that have the same economic and political nature and share the same policy considerations. On the other hand, despite the complexity of domestic tax rules, international rules that are usually inclined in bilateral treaties are general and vague.[224] Bilateral tax treaties often share the same definition and follow the same structure. Therefore, the issue at stake is whether tax treaties will limit the application of CFC rules.

A closer look at the structure of tax treaties is necessary for further understanding of the interaction of CFC rules with tax treaties. The look is going to be limited to the OECD model since most modern tax treaties are substantially based on the OECD model.[225] Tax treaties share the same structure which is divided into seven chapters. Tax treaties are structured based on the following consequence; Chapter I the 'Scope of the Convention', Chapter II 'Definitions', Chapter III 'Taxation of Income', Chapter IV 'Taxation of Capital', Chapter V 'Methods of Elimination of Double Taxation', Chapter VI 'Special Provisions' and Chapter VII 'Final Provisions'.[226] Chapters III and IV of the OECD model have a distributive function. They contain the rules that classify the jurisdiction to tax and they allocate taxing rights to the contracting states.[227]

The distributive rules[228] of tax treaties are where the contracting states agree on the division and the allocation of taxing rights between the contracting states. They, therefore, serve as the basis of the

[223] Sriram Govind, The Relationship Between Domestic Specific Anti-Avoidance Rules and Tax Treaty Law, in D. W. Blum and M. Seiler, *Preventing Treaty Abuse,* Volume 101 of Series on international tax law (Linde 2016) p. 545
[224] Daniel Sandler, *Tax Treaties and Controlled Foreign Corporations,* (Kluwer Law International 1998) p. 18
[225] B. J. Arnold, *International Tax Prime,* Third Edition (Kluwer Law International BV 2016) p. 7
[226] OECD Model 2017 op. cit. and United Nations – 2017, *Model Double Taxation Convention between Developed and Developing Countries,* (New York 2018) (UN Model 2017)
[227] Sandler op. cit. p. 19
[228] Including both Chapter III and IV,

elimination of both international double taxation and international non-double taxation.[229] The distributive articles, however, are relevant only to the taxes covered by the tax treaty which are inclined in Article 2[230] of the OECD model convention. The attribution of taxes under the distributive rules follow the same pattern in most of tax treaties. The distributive articles may give exclusive rights to tax to one of the contracting states by stating that a specific type of income 'shall be taxable only in ...', then the exclusivity of the right requires the other contracting state to exempt that income from tax.[231] The distributive articles may also give a non-exclusive right to tax if it states that a specific income 'may be taxed in ...', then both states have the right to tax. However, the non-exclusive right to tax may be limited by requiring one of the contracting states not to levy more than a specific tax rate. Although non-exclusive rights may be granted to the contracting states, chapter V is where relief from double taxation takes place, through methods for the elimination of double taxation.

CFC rules are part of domestic anti-avoidance measures, and the relationship between domestic anti-avoidance rules and tax treaties has been discussed over the years. The question to whether tax treaties limit the application of domestic anti-avoidance rules in situations covered by tax treaties also was raised. Tax administrations, courts and scholars have different opinions about the applicability of CFC rules in case of the existence of tax treaties and about the compatibility of the rules with tax treaties. CFC rules, or Subpart F, were mentioned in the 1987 report by the OECD on 'International Tax Avoidance and Evasion',[232] and the OECD report 'Double Taxation Conventions and the Use of Base Companies",[233] and were later incorporated in the 1992 OECD MC commentary update.[234]

Paragraph 43 of the base company report stated:

"*Under existing counteracting measures (subpart F type measures), the country imposes a tax on residents who are shareholders in the foreign base company. The foreign company as such is not taxed; generally, the income which gives rise to the taxation does not originate in the country of the base company but in the taxing country itself or in a third country. A tax treaty between the country using the counteracting legislation and the country of the base company usually protects, however, income flows*

[229] M. Helinen, A. J. M. Jimenez and IFA, *The notion of tax and the elimination of international double taxation and double non-taxation*, Cahiers de droit fiscal international, vol. 101B (IFA 2016) p. 163
[230] OECD Model 2017 op. cit. Article 2 'Taxes Covered'
[231] Daniel Sandler, *Tax Treaties and Controlled Foreign Corporations,* (Kluwer Law International 1998) p.19
[232] OECD, *International Tax Avoidance and Evasion: Four Related Studies,* (OECD 1987) No.1 at 62
[233] OECD, *Double Taxation Conventions and the Use of Base Companies,* (OECD 1987) (OECD – Base Company Report)
[234] OECD, *Model Tax Convention on Income and on Capital,* (Paris 1992) (Starting Now 'OECD Model 1992')

only between these two countries. The first-mentioned country may therefore claim that the tax imposed under the counteracting legislation does not come under the scope of the said tax treaty.".[235]

The 1992 OECD MC commentary on Article 1 states:

"*Other forms of Abuse of tax treaties (e.g. the use of base company) and of possible ways to deal with them such as "substance-over-form" rules and "sub-part F type" provisions have also been analysed.*".[236]

From 1992 to 2003[237] the OECD mentioned that substance-over-form and subpart F rules are part of the basic domestic rules of national tax law. These rules are not addressed in tax treaties and are therefore not affected by them. The OECD commentary also mentioned the existence of a dissenting view by member states where it was held that such rules are subject to the general provision of tax treaties, especially that tax treaties also contain provisions aimed at counteracting its improper use.[238]

The commentary adds that "*The majority of Member countries accept counteracting measures as necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, ...*".[239]

Therefore, the commentary saw that the majority of member states believed that CFC rules were in accordance with tax treaties and the minority of them believed the opposite. Nevertheless, by that time the issue of CFC rules and compatibility with tax treaties was not yet settled, and the OECD was just reflecting on the opinion of member states. Most of the opinions mentioned in the OECD commentaries and reports before 2003 were reflecting the views of tax administrations of member states and they were not always in line with experts and case law views on the same issue.[240]

However, in the 2003 update[241] of the OECD model convention, the commentary changed. The commentary stated explicitly that CFC rules are in accordance with tax treaties.[242] It is further stated that states are not anymore required to clarify that CFC rules are in line with tax treaties and adds *"It is recognised that controlled foreign company legislation ... is not contrary to the provisions of the*

[235] OECD Base Company Report, para. 43
[236] OECD Model 1992 op. cit. Art. 1 note 22
[237] M. Lang, H. Aigner et al. op. cit. p. 29
[238] OECD Mode 1992 op. cit. commentary to Art. 1 note 23
[239] Ibid, note 26
[240] Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 52
[241] OECD, *Model Tax Convention on Income and on Capital,* (Paris 2003) (Starting Now 'OECD Model 2003')
[242] Ibid, commentary to Art. 7 note 10.1 and commentary to Art. 10 notes 37 to 39; and OECD Model 2017 op. cit. Commentary to Art. 7 note 14 and commentary to Art. 10 notes 37 to 39

Conventions."[243] However, it also mentioned and referred to a dissenting view of different countries that opposed the opinion taken by the OECD commentary.[244] However the debate of the compatibility of CFC rules with tax treaties still exist, and it is far from settled[245], that will be more clear through the next reading of the arguments in favour or against CFC rules compatibility with tax treaties. The main arguments made against CFC rules compatibility were based on article 7(1) 'Business Profits' and 10(5) 'Dividends' of the OECD model convention.

4.1 CFC rules and the Compatibility with Tax Treaties:

The compatibility of CFC rules with tax treaties which is going to be discussed in this section of the work is based on CFC features that have been explained in chapter 2 in the context of the OECD final report.[246] The compatibility discussion is quite complex, which is a result of the different features of CFC rules. As we have seen previously, CFC rules are applied based on either the entity approach, where one stream of the CFC income is attributable, or the transactional approach, where all or no CFC income is attributable. CFC income, on the other hand, is attributed either based on deemed dividends approach, where the CFC income will be treated as deemed distributed to the parent shareholder, or based on flow-through approach, where the CFC entity is disregarded and the CFC income will be treated as it is earned by the parent shareholder.

The discussion of the compatibility of CFC rules with tax treaties may differ depending on the characterisation of CFC income. CFC legislation with a transactional approach may be in conflict with Article 7 of the OECD MC 'Business Profits', where the entity approach may be in conflict with Article 10 of the OECD MC 'Dividends'. The issue is also influenced by the way that the CFC income is attributed to the parent shareholder, from a deemed dividends approach to a flow-through approach.

4.1.1 CFC Rules and Article 7 of the OECD MC:

The first argument[247] is based on Article 7 of the OECD MC 'Business Profits'. This argument is in regard of CFC rules that are based on transactional/flow-through approach, where the CFC income is characterised as business profits. The characterisation is based on the fact that the parent jurisdiction, under CFC rules with flow-through approach, disregard the CFC and treat the income as it has been

[243] OECD Model 2003 op. cit. Commentary to Art. 1 note 23; and OECD Model 2017 op. cit. commentary to Art.1 note 81
[244] OECD Model 2003 op. cit. Commentary to Art. 1 note 27.4 to 27.9; and OECD Model 2017 op. cit. commentary to Art. 1 note 110
[245] Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 52
[246] Final Report 2015 op. cit.
[247] M. Lang, H. Aigner et al. op. cit. p.32; and Sandler op. cit. p. 96; and Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 55; and B. J. Arnold, *Tax Treaties and Tax Avoidance: the 2003 Revision to the Commentary to the OECD Model*, Bulletin – Tax Treaty Monitor (IBFD 2004) p. 252

earned by the shareholder. However, the argument also targets CFC rules based on the entity/deemed dividends approach which attribute not all the CFC income but specific streams of income. That is if, in this case, these streams of income accumulated constitute business profits.

The argument considers that article 7(1) of the OECD MC prevent the application of CFC rules. Where Article 7 (1) of the OECD MC states:

"*Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.*"[248]

According to Art. 7(1) of the OECD MC, the business profits of a resident company of State A shall be only taxable in state A, unless these profits are attributable to a permanent establishment (PE) in State B. Hence, State B may tax only the business profits that are attributable to the PE in state B. Likewise, in the case if CFC rules. The business profits of a company (the CFC) resident in state A (The CFC state) shall be only taxed in state A (the CFC state), unless the CFC carries on business in state B (the parent state) through a PE, here state B (the parent shareholder state) may tax only the business profits that are attributable to the PE. Accordingly, state B (the parent shareholder state) is precluded from taxing business profits of a company (the CFC) located in state A (the CFC state), unless these profits are connected to a PE located in state B (the parent shareholder state).

Moreover, the argument goes on and states that the control criteria in CFC rules does not constitute a permanent establishment. Where, Art. 5(7) of the OECD MC states:

"*The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.*"[249]

Then, according to article 5(7) of the OECD MC, if a resident of a contracting state controls a company in the other contracting state, the controlling criterion shall not constitute a permanent

[248] OECD Model 2017 op. cit. Art. 7(1)
[249] OECD Model 2017 op. cit. Art. 5(7)

establishment in the other contracting state. In the CFC rules case, the CFC is controlled by a resident of the CFC rules state. Therefore, the control criterion of the parent shareholder over the CFC shall not mean that the CFC constitute a PE in the shareholder state. Moreover, it is quite rare for a foreign subsidiary to have a permanent establishment in the residence state of the controlling shareholder.[250]

Accordingly, based on the literal interpretation of the previous articles, the application of CFC legislation is not in accordance with article 7(1) of the OECD MC. Therefore, business profits of a CFC must not be subject to tax in the residence state of the shareholder unless the CFC has a permanent establishment there. Hence, the residence country of the shareholder arguably[251] cannot tax the profit of the CFC in the hands of the resident's shareholders.

This argument was also in accordance with the case law decision of the French *Conseil d'Etat (Supreme Administrative Court)* reached on 28 June 2002 in the Schneider case.[252] The case is regarding the application of French CFC rules over a Swiss subsidiary of Schneider SA, a company resident in France. In short, the court assumed that the income that is subject to tax under French CFC legislation is the income of a Swiss company. Therefore, the court saw that the France-Switzerland tax treaty of 1966 and amended in 1969, was an obstacle for the application of the French CFC legislation to a Swiss subsidiary of a resident company in France Schneider SA. According to Art.7(1) of the treaty, France was precluded from taxing the income of the Swiss subsidiary, since it is subject to tax in Switzerland and did not have a permanent establishment in France. The court was objectively eliminating double taxation and ruled out any other possible interpretation of the treaty provisions.[253]

On the other hand, **the counter-argument** of the majority of the OECD member states and most countries with CFC legislation is that the previous argument has a problem where it disregards the legal separation between the parent shareholder of the CFC and the CFC.[254] Moreover, the subject of tax under CFC legislation is the resident shareholder of the CFC not the CFC itself.

Note 14 of the OECD MC commentary on Article 7 states:

"*The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprise of the other Contracting State. As confirmed by paragraph 3 of Article 1, the*

[250] B. J. Arnold, *International Tax Prime,* Third Edition (Kluwer Law International BV 2016) p. 25
[251] Daniel Sandler, *Tax Treaties and Controlled Foreign Corporations,* (Kluwer Law International 1998) p. 93
[252] Société Schneider Electric, 28 June 2002, Conseil d'Etat, No. 232276, RJF 10/2002, International Tax Law Reports 2002, no 4, p. 1077 et seq.
[253] Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 51
[254] B. J. Arnold, *The Relationship Between Controlled Foreign Company Legislation and the Tax-Sparing Provision of Tax Sparing,* Tax Notes International (July 1989) p. 28

paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits ...".[255]

From the reading of the OECD MC commentary and the understanding of the counter argument, Article 7(1) does not prevent the application of CFC rules. Where, literal reading of Article 7(1) would preclude the contracting state from taxing the profit of an enterprise in the other contracting state, unless what is linked to a permanent establishment situated in the other state. Nevertheless, Article 7(1) does not preclude the residence state of taxing its own residents even when computing the income in reference to the other state. The function of Article 7 is to allocate the jurisdiction to tax business profits of an enterprise resident in one of the contracting states. However, it limits the jurisdiction of the source country to the taxation of the profits of the PE.

In the case of CFC legislation, on the other hand, the tax does not deal with or target the source taxation, instead the tax is imposed based on the residence of the shareholder.[256] CFC legislation taxes the resident shareholder on income that is computed in reference to the CFC and does not tax the CFC itself. Hence, a proper application of Article 7 of the OECD MC in the French case mentioned before, would not preclude France which is the residence state of the parent shareholder from taxing the resident parent company.[257] The same view is also later reiterated in the BEPS project.[258]

This position is also reflected in the Japanese Supreme court decision in GYO-HI[259] case. The court confirmed the compatibility of CFC rules with Article 7(1) of the Japan-Singapore tax treaty (1995). The court reached the same conclusion that has been already stated by the OECD commentary on Article 7, wherein the court's opinion the application of the Japanese CFC rules was aimed at the taxation of the income of the resident shareholder of Japan, not the Singapore CFC nor its income.

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[255] OECD Model 2017 op. cit. Commentary to Art. 7 note 14

[256] Daniel Sandler, *Tax Treaties and Controlled Foreign Corporations,* (Kluwer Law International 1998) p. 99

[257] Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 55

[258] Daniele Cané, *Controlled Foreign Corporation as Fiscally Transparent Entities. The Application of CFC Rules in Tax Treaties,* (World Tax Journal 2017) p. 527

[259] Y. Hegawa, National Report. Japan, in, *International Tax Avoidance and Tax Treaties: Application of Anti-Avoidance Provisions,* 64th IFA Congress (Rome 2010) p. 463-464

4.1.2 CFC Rules and Article 10 of the OECD MC:

The second argument says that CFC rules may also be in conflict with article 10(5) 'dividends' of the OECD MC. The argument considers that CFC legislation that is based on a deemed dividends approach and the tax imposed in the jurisdiction with CFC legislation is aimed at the undistributed dividends of the CFC, as an opinion for inconsistency, violates the article 10(5) of the OECD MC.

Article 10 of the OECD MC states:

"*Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other state.*".[260]

In the case of CFC rules, article 10 says that the dividends paid by a company (the CFC) resident in State A (the CFC state) to a resident in state B (the parent shareholder state) may be taxed in state B.

Nevertheless, Article 10(5) of the OECD MC states:

"*Where a company which is a resident of a Contracting State derives profits of income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.*".[261]

Under Article 10(5), State B (the parent shareholder state) cannot impose tax on dividends paid by a company (the CFC) resident is State A (the CFC state), unless these dividends paid to a resident of State B. Moreover, State B (the parent shareholder state) is precluded from imposing tax even if the profits out of which the dividends are paid are derived from that state. Furthermore, the second point which is the core of CFC rules, State B (the parent shareholder state) is precluded from taxing the undistributed profits of a company (the CFC) resident in state A (the CFC state) even if the undistributed profits are wholly or partially derived from State B (the parent shareholder state).

[260] OECD Model 2017 op. cit. Article 10
[261] OECD Model 2017 op. cit. Article 10(5)

Accordingly, several taxpayers and tax havens argue[262] that CFC legislation is in clear violation to both the wording and the spirit of Article 10(5). Where CFC rules impose a tax on some or all of the undistributed profits of a non-resident foreign corporation. In other words, the parent jurisdiction, under CFC legislation, taxes the companies undistributed profits of the CFC that is located in another jurisdiction.

Professor Klaus Vogel also has his say about the violation of the ban of extraterritoriality[263] stated in Article 10(5), where he stated: "*Since this would subject undistributed profits of a non-resident company to domestic taxation, the objection is obvious that this kind of taxation is inconsistent with Art. 10(5) of the Model Convention*.".[264] However, Professor Vogel has dismissed this conclusion.[265]

On the other hand, **the counter argument** says that although Article 10(5) in the second part may preclude a country from taxing a non-resident company on its undistributed profits. There is nothing that prevent a country from taxing its own residents. That appears to be the opinion of all countries with CFC legislation and also the opinion of the OECD.

Moreover, the OECD MC Commentary on Article 10 confirms that paragraph 5 of article 10 does not prevent a country from taxing its residents' taxpayers.

Note 37 of the OECD MC commentary on Article 10 stipulates:

"*As confirmed by paragraph 3 of Article 1, paragraph 5 cannot be interpreted as preventing the State of residence of a taxpayer from taxing that taxpayer, pursuant to its controlled foreign companies legislation or other rules with similar effect, on profits which have not been distributed by a foreign company. Moreover, it should be noted that the paragraph is confined to taxation at source and, thus, had no bearing on the taxation at residence under such legislation or rules. Besides, the paragraph concerns only the taxation of the company and not that of the shareholder.*".[266]

The commentary confirms that Article 10(5) precludes the residence state from taxing the CFC itself, nor tax the undistributed profits of the CFC itself. However, under CFC rules the tax is neither imposed on the CFC nor on its undistributed profits. Instead, the tax is imposed on the resident

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[262] B. J. Arnold, *Tax Treaties and Tax Avoidance: the 2003 Revision to the Commentary to the OECD Model*, Bulletin – Tax Treaty Monitor (IBFD 2004) p. 253
[263] Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 56
[264] K. Vogel, *Klaus Vogel on Double Taxation Conventions,* (3rd, 1997) Art. 10 (260)
[265] Michael Lang, *CFC Regulations and Double Taxation Treaties,* Bulletin – Tax Treaty Monitor (IBFD 2003) p. 56
[266] OECD Model 2017 op. cit. Commentary on Art. 10 note. 37

shareholder of the CFC. Accordingly, Article 10(5) of the OECD MC does not prevent a state from taxing it residents' taxpayer and therefore the article does not prevent the application of CFC legislation.

Further, it has been disputed whether the purpose tax treaties is to go beyond avoiding double taxation to the prevention of tax avoidance.[267] Where for this, the commentary on Article 1 clearly indicates that: "*The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchange of goods and services, and the movement of capital and persons. As confirmed in the preamble of the Convention, it is also a part of the purposes of tax conventions to prevent tax avoidance and evasion.*".[268]

As we have seen previously, some commentators have argued for the incompatibility of CFC rules with tax treaties[269] and some others argue for the consistency of the rules with tax treaties. Other authors have argued that despite not violating the treaty from a technical view, CFC rules violates the spirit of tax treaties.[270] For this opinion, tax treaties should be interpreted broadly and liberally in accordance with their spirit. Under this point of view, the taxation of resident shareholders on their participation of the CFC according to CFC rules is broadly equivalent to taxing the CFC itself. Therefore, the imposition of tax on the resident shareholder of the CFC is in violation of the spirit of tax treaties. One more opinion which believes that the commentary should take a clear stance and say that although CFC rules may infringe article 7 paragraph 1 or article 10 paragraph 5, or at least the spirt of the articles. Such infringement is accepted and justified due to the anti-avoidance role of CFC rules.[271] While tax treaties are often complicated and vague such position may avoid further complexity of tax treaties.

After reviewing the arguments against and for the compatibility of CFC legislation with tax treaty provisions, we also see that CFC legislation is compatible with tax treaties. Where, the subject of tax under CFC legislation is the resident shareholder of the CFC and the not the CFC. Moreover, CFC legislation is an anti-avoidance measure and tax treaties should not be interpreted to help tax avoidance.

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[267] M. Lang, H. Aigner et al. op. cit. p. 31

[268] OECD Model 2017 op. cit. Commentary on Art. 1 note. 54; see also OECD Model 2017 op. cit. Introduction, note. 16.1: "As a result of work undertaken as part of the OECD/G20 Base Erosion and Profit Shifting Project, in 2014 the Committee decided to amend the title of the Convention and to include a preamble. The changes made expressly recognise that the purposes of the Convention are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of the Convention to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Given the particular base erosion and profit shifting concerns arising from treaty-shopping arrangements, it was also decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties, it being understood that this was only one example of tax avoidance that the Contracting States intend to prevent."

[269], See more, Michael Rigby*, A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism,* 8 Australian Tax Forum (1991) p. 322-331

[270] Sandler op. cit. p. 2019: B. J. Arnold, *The Relationship between Controlled Foreign Corporations Rules and Tax Sparing Provisions in Tax Treaties: A New Zealand Case,* Bulletin for International Taxation (IBFD 2018) p. 434

[271] Johann Muller, *Is it not Time to Correct the OECD MC Commentary on CFC's?,* (Kluwer International Tax Blog 2015) <http://kluwertaxblog.com/2015/05/18/is-it-not-time-to-correct-the-oecd-mc-commentary-on-cfcs/> Accessed 15 February 2019

Although, the conflict between CFC rules and tax treaties is quite complex. The diversity of features of CFC regimes makes it more complicated and more debatable. Further complications are due to the fact that several countries have included different features of CFC rules ranging between the transactional approach with the deemed dividends and the entity approach with the flow-through approach to other combined features. Additionally, the recommendations of the OECD in the final report provides several options to jurisdictions for designing their CFC rules, from the definition of the CFC income to the way of attributing the income. It seems that the debate of the compatibility of CFC rules and tax treaties, although very common, is coming to a minimal place and the issue is settled at least in the countries with CFC rules which is quite a significant number. Moreover, the recommendations of the OECD in the BEPS project and the ATA Directive and the introduction of CFC rules by several countries, it is going to be a tough mission to argue for the incompatibility of CFC rules with tax treaties. Therefore, as CFC rules are considered, by the majority, to be compatible with tax treaties that lead us to question whether double tax situations of CFC rules should benefit of tax treaties.

4.2 CFC Rules and Treaty Benefits:

CFC rules generally contain measures to provide direct or indirect foreign credit for taxes paid by the CFC on the CFC income that is subject to tax under CFC rules. The rules are aimed at avoiding double taxation of CFC rules and they are a unilateral measure by the state applying CFC rules. However, unilateral rules may not be sufficient to eliminate double taxation of CFC rules, and therefore a benefit of tax treaties is being addressed.

Considering all mentioned above, the issue of the compatibility of CFC rules and tax treaties has been disputed heavily. Still, the dispute goes further to whether tax treaty benefits should be granted in cases of double taxation situations generated by the application of CFC rules. The leading position of countries with CFC legislation is that CFC rules are in line with tax treaties and the imposition of tax according to CFC legislation is not in breach of treaty provisions. Tax treaties do not prevent contracting states from taxing their residents' taxpayers, moreover, the tax imposed by CFC rules is on the resident shareholder of the CFC rather than on the CFC itself. Hence, some authors argue that since tax treaties do not limit the contracting state from taxing its residents, it should follow that tax treaties should not require the contracting state to provide any relief for double taxation of CFC rules.[272] Moreover, double taxation of CFC rules represents economic double taxation which is out of the scope of tax treaties. On

[272] B. J. Arnold, *The Relationship Between Controlled Foreign Company Legislation and the Tax-Sparing Provision of Tax Sparing,* Tax Notes International (July 1989) p. 28

the other hand, some authors provide a different opinion; for them, CFC rules are no different from any other taxable event in domestic law.[273]

If we analyse the issue in continuous logic with the compatibility discussion, it is quite contradicting to ask for a treaty benefits for CFC rules. That is because, it is inconsistent to say that CFC rules are compatible with tax treaties due to the fact that the rules are imposed on the resident shareholder of the CFC, but tax treaties should benefit the already taxed residents under CFC rules and provide for double taxation relief. However, this view considers that the resident's taxpayer as having paid the foreign taxes that have been paid by the CFC. On the other hand, a more consistent position is that tax treaties neither prevent the contracting states from applying CFC rules nor requires the taxing state to provide a credit for taxes paid by the CFC.[274] Moreover, double taxation situations of CFC rules constitute economic double taxation and they are, therefore, outside the scope of tax treaties.

Therefore, our opinion considers that the position which indicates that tax treaties do not prevent the application of CFC rule but still, they should require the CFC rules country to provide a credit to foreign taxes paid by the CFC, under the treaty relief provisions, is contradicting itself. Where double taxation of CFC rules constitutes economic double taxation and is not covered by tax treaties. In other words, in order to benefit of double taxation relief under tax treaty law, we need to prove that double taxation of CFC rules is a juridical double taxation. However, we have already seen that double taxation of CFC rules constitutes economic double taxation, where we have one income (the CFC income) taxed in the hand of two different taxpayer (the CFC and the CFC shareholder). Therefore, assuming that we are convinced that double taxation constitutes juridical double taxation, where the same CFC income is taxed twice in the hand of the same taxpayer, this lead us that CFC rules are incompatible with tax treaties. Therefore, the issue here is that CFC rules should not, in the first place, be applicable in tax treaty scenario. Tax treaties, then, should prevent the application of CFC rules before reaching the issue of benefiting from tax treaties.

Accordingly, CFC legislation does not breach tax treaty provisions, nor the relief provisions of the convention are applicable for the relief of double taxation situations generated by the application of CFC rules.

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[273] M. Lang, H. Aigner et al. op. cit. p. 38

[274] B. J. Arnold, *The Relationship between Controlled Foreign Corporations Rules and Tax Sparing Provisions in Tax Treaties: A New Zealand Case,* Bulletin for International Taxation (IBFD 2018) p. 438

4.2.1 CFC Rules and Tax Sparing Provisions:

Another issue has raised in regards of tax sparing provisions in some tax treaties and tax incentives provided to a CFC in a situation of a tax treaty with tax sparing provision. Th issue is to whether a CFC which is provided a tax incentive in the CFC country should benefit from the tax sparing provision in the tax treaty. CFC rules, as we have seen before, generally provide credit for foreign taxes paid by the CFC. However, taxes that are payable and consequently not paid are not included in the foreign tax credit provided by CFC rules. The question to whether a tax treaty with a tax sparing provision should require the CFC rules country to provide a credit for the taxed spared in the CFC country. This issue was discussed in a quite new, March 2018, decision by the New Zealand Court of Appeal in the case of Commissioner of Inland Revenue v. Patty Tzu Chou Lin,[275] regarding the tax treaty signed between New Zealand and China 1986.[276]

The issue is concerning the application of New Zealand CFC rules on a resident of New Zealand regarding the income of a Chinese controlled foreign corporation. The New Zealand taxpayer is arguing that she should benefit from the tax sparing provision in the New Zealand-China double tax treaty. New Zealand CFC rules provide credit for foreign taxes paid by the CFC, however no CFC rules, including the New Zealand rules, provide credits for foreign taxes payable by the CFC. Accordingly, the Chinese tax paid by the CFC is credited against the tax of the New Zealand taxpayer, but the tax spared (due to tax incentive provided to the CFC in China) did not benefit from the credit provided. The decision of the case has several aspects and discusses different points, this is mainly because the tax treaty was signed before the introduction of the New Zealand CFC rules, and also before the 1992 or the 2003 OECD models which provided more explicit analysis of the relationship between CFC rules and tax treaties. Therefore, our use of this case is limited to whether the taxpayer should benefit from the sparing provision of the tax treaty.

The Court of First Instance, the New Zealand High Court,[277] agreed that the taxpayer should be granted relief according to the tax treaty. That decision was based on a broad purposive approach to the interpretation of the treaty.[278] The decision of the Case was reasoned to the extent to which the Hight Court considered that both (i) the Chinese tax paid by the Chinese CFC on the CFC income (ii) and the

[275] NZ: CA, 8 Mar. 2018, *Commissioner on Inland Revenue v. Patty Tzu Chou Lin 38*
[276] Agreement between the Government of New Zealand and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect of Income. (16 September 1986, amended through 1997), Treaties IBFD.
[277] NZ: HC, 12 May 2017, *Lin v. Commissioner of Inland Revenue,* 969
[278] B. J. Arnold, *The Relationship between Controlled Foreign Corporations Rules and Tax Sparing Provisions in Tax Treaties: A New Zealand Case,* Bulletin for International Taxation (IBFD 2018) p. 438

Chinese tax deemed to be paid by the Chinese CFC on the CFC income were taxes paid by the New Zealand resident taxpayer for tax treaty purposes. Here, the court had disregarded the legal separation of the Chinese entity and the New Zealand resident shareholder, which consequently qualified the case as a juridical double taxation which is covered by the tax treaty.

Nonetheless, the Court of Appeal reversed the High Court's decision, taking the traditional view of the relationship between CFC rules and tax treaties. Accordingly, the court said that the tax imposed under New Zealand CFC rules is aimed at the New Zealand resident shareholder of the Chinese CFC, not on the Chinese CFC itself, and the Chinese tax paid and payable on the CFC income should not be deemed paid or payable by the New Zealand resident taxpayer. Therefore, the Court of Appeal concluded that the elimination of double taxation in the treaty is limited to legal double taxation, and accordingly it does not cover double taxation of CFC rules.[279]

It seems consistent, logical and easy to predict the majority opinion about the benefit of sparing provision in tax treaties in CFC rules situations. It might actually make sense from a technical point of view also. The traditional view would prevail once more since tax treaties do not prevent the contracting state from taxing their residents under CFC rules. They do not require them to provide a credit for taxes paid by the foreign CFC and also do not require them to provide relief for taxes spared to the CFC on the CFC income under the sparing provision of the tax treaty. Additionally, and more precisely, tax treaties do not apply to economic double taxation.

Another point of view is worth mentioning where, for some authors, the denial of the treaty benefits does not constitute a breach of the sparing provision of the treaty. It is reasonable to say that the treaty cannot impose a positive obligation to provide tax sparing relief since the treaty is irrelevant to the application of CFC rules. Nevertheless, the denial in this situation is in breach of the spirit of the tax sparing provision.[280] The justification of this position is quite impressive considering that a treaty which contains a tax sparing provision is reflecting a mutual understanding that the company/CFC income is not taxed until it is distributed to the parent shareholder. The negotiation of tax sparing provision would not be necessary knowing that the benefit could be denied under CFC rules. Therefore, although there is no breach of the treaty wording and literal interpretation, it breaches the spirit of the treaty and undermines the tax sparing provisions function.

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[279] B. J. Arnold, *The Relationship between Controlled Foreign Corporations Rules and Tax Sparing Provisions in Tax Treaties: A New Zealand Case,* Bulletin for International Taxation (IBFD 2018) p. 432

[280] Michael Rigby, *A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism,* 8 Australian Tax Forum (1991) p. 340

Accordingly, our opinion is that CFC rules cannot benefit from the relief provisions in tax treaties. Tax treaties do not prevent the application of CFC rules because the subject of tax in CFC legislation is the resident shareholder of the CFC not the CFC itself. Therefore, double taxation situation that are generated by the application of CFC rules constituted economic double taxation. Accordingly, taxes paid or payable by the CFC are not taxes paid or payable by the shareholder of the CFC. Hence, tax treaties do not prevent the application of CFC rules and shall not relief economic double taxation of CFC rules.

Chapter v: The Elimination of Double Taxation of CFC Rules.

1. Are the Unilateral Domestic Measures Enough?

CFC legislation is far more complex than what is shown in the literature, and its rules differ between jurisdictions.[281] In general, CFC legislation is aimed at taxing a non-resident foreign corporation having it controlled by a resident shareholder in the jurisdiction applying the CFC legislation. Moreover, in order to apply CFC legislation, specific criteria should be fulfilled in the controlled foreign corporation and its shareholder. The rules subject to tax a resident shareholder of a non-resident foreign corporation (CFC) on the non-resident foreign corporation income that has not yet been distributed to the parent resident shareholder. CFCs that are subject to CFC provisions are usually located in low tax jurisdictions, however, the low-taxation criterion is defined according to domestic rules of each jurisdiction and may differ from one country to another. The very fact that a jurisdiction with CFC rules tax a resident shareholder on the income of a non-resident foreign corporation (the CFC income), in itself, raise the risk of double taxation.

Double taxation of CFC rules (chapter IV 3.1) in general constitutes economic double taxation. That is because juridical double taxation occurs when the same stream of income is subject to identical or comparable taxes in two, or more states in the hand of one taxpayer. Economic double taxation, on the other hand, is when the same stream of income is subject to identical or comparable taxes in two, or more states in the hand of two different taxpayers. Hence, double taxation of CFC legislation happens when the same CFC income is subject to the same or comparable taxes in the hand of two different taxpayers. Which result of the fact that the parent shareholder of the CFC is a different separated legal entity of the CFC itself, pursuant to the legal separation principle. The same CFC income, therefore, may be subject to tax in the CFC jurisdiction and later the same income may be subject to tax in the parent shareholder's jurisdiction under CFC rules in the hand of the resident shareholder. Thus, double taxation that results from the application of CFC rules is considered to constitute economic double taxation.

The classification of double taxation of CFC rules as juridical or economic double taxation is very relevant in regard to whether such double taxation situation could benefit from tax treaty relief. Although we have seen previously (in chapter IV 4.2) that the majority of countries with CFC rules and the commentary of OECD MC deny any benefit from tax treaties for double taxation of CFC rules. Nevertheless, CFC legislation generally includes unilateral domestic provisions to prevent or eliminate doublet taxation situations. Both, the OECD, in the final report, and the EU ATA directive stressed on the

[281] Axel Prettl, *Influence of anti-tax avoidance rules on profit shifting and real FDI – examining CFC rules,* University of Tuebingen (February 2017) p. 26

need for preventing and eliminating double taxation situations of CFC rules and recommended for the inclusion of double taxation relief provisions in CFC legislation.

Whereas, in the absence of relief provisions in CFC legislation there is a high risk of double taxation situations. The issue may also pose risks if the relief provisions, inclined in CFC rules, are not effectively preventing or eliminating double taxation. The risk of double taxation could occur, especially where It might be quite surprising to know that there are some jurisdictions with CFC rules that do not contain any relief provisions.[282]

Hence, we could see that double taxation situations of CFC rules are present and there is a high possibility that they will arise in the absence of relief provisions in CFC legislation. Moreover, the risk is still present with the existence of ineffective such provisions in CFC legislation. Therefore, we are tempting to answer the main question of whether unilateral domestic measures are enough or not, in the light of the recommendations provided either in the OECD Action plan 3 final report or in the EU ATA directive. Accordingly, we can say that the answer to the question depends on the relief measures that are included in the CFC legislation. However, we have already seen that the relief rules provided by the OECD final report and the EU ATA directive may be effective to prevent or eliminate most double taxation situation of CFC rules, nevertheless, they may be not enough for a full prevention or elimination of all double taxation situation generated by the application of CFC rules.

Moreover, Considering, if we may, that the recommendations of the OECD in the final report regarding the rules for preventing and eliminating double taxation of CFC rules (chapter III 3.1) are best practice for the elimination of double taxation situation in countries with CFC rules. In addition to the assumption that countries with CFC rules will take into consideration the recommendations and incorporate relief provisions in their CFC legislation. The issue of double taxation of CFC rules may still exist and is not solved entirely. Where, there are several situations of double taxation situations of CFC rules that are not discussed in the final report and yet not solved, (Chapter IV 3.14) therefore, the final report recommendations are not efficient enough to solve all situation of CFC rules double taxation.

Moreover, in the public discussion draft of the OECD final report, which is still relevant for the final recommendations, some of the respondents highlighted the practical complexity of relieving double taxation of CFC rules and indicated that the OECD *"... underestimates the practical difficulties and*

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[282] B. J. Arnold, *The Relationship between Controlled Foreign Corporations Rules and Tax Sparing Provisions in Tax Treaties: A New Zealand Case,* Bulletin for International Taxation (IBFD 2018) p. 438. " *.... Unlike New Zealand, several countries with CFC rules do not grant credits under their domestic law for foreign taxes paid by CFCs.*

complexity in calculating double taxation relief and assumes that effective relief will be generally available ..." and it adds *"... the Discussion Draft does not seem to take into account CFC jurisdictions which do not or will not adhere to the recommendations outlined in paragraph 154-155.*"[283] of the final report. The previous comments mentioned in the public discussion draft of Action Plan 3, which was aimed at getting the public opinion on the draft of the final report, is still relevant and targets two main important issues. The complexity of relieving double taxation of CFC rules and what it consists of difficulties, in addition to the fact that not all jurisdictions will follow the rules provided by the OECD in the final report.

Nevertheless, it should be admitted that the recommendations provided in final report of Action plan 3 are sufficient for the relief of most of the double taxation situations of CFC rules. Besides, the final report did not deny the existence of further double taxation situations of CFC rules. Instead, they actually advised countries to provide adequate provisions for the elimination of double taxation of CFC rules.

Consequently, we could see that double taxation of CFC legislation is very common and could arise in several situations, however, in general they should be mitigated by the inclusion of domestic unilateral relief measures in the domestic legislation of the country that is applying CFC rules. However, concerns of the efficiency of unilateral measures for the full relief of double taxation situations of CFC rules still arise. Moreover, assuming that CFC legislation contains relief provisions of double taxation which may, or may not, match the recommendations of the OECD in the final report, there are still several situations where double taxation could occur.

In the same context, the OECD, in the policy considerations and objectives of the final report, stressed on the a very important aspect of CFC legislation. Where, CFC rules should strike a balance between tackling BEPS activities by taxing CFC income and maintaining competitiveness (Chapter II 3.1). Likewise, the EU ATA directive recommended member states to design their CFC rules bearing in mind the importance of avoiding double taxation of CFC rules (Chapter II 4.5).

Hence, according to all of what has been mentioned in this work, a conclusion could be drawn in regard to the efficiency of the unilateral domestic relief measures included in CFC legislation. We can say that the efficiency of preventing or eliminating double taxation situations of CFC rules depends on what unilateral relief provisions are included in a specific CFC legislation. Moreover, the recommendations that are provided in both the OECD Action Plan 3 and the EU ATA directive, although they are effective in several situations, are not entirely sufficient for a full prevention and elimination of all double taxation

[283] OECD, *Public Discussion Draft BEPS Action 3: Strengthening CFC rules*, (2015) p. 252

situation generated by CFC rules. Therefore, we are going to explore the possible solutions that jurisdictions with CFC legislation may apply in order to reach the best result for an effective prevention and elimination of double taxation situations by the application of CFC legislation.

2. Possible Solutions for the Elimination of Double Taxation of CFC Rules:

Double taxation situations generated from the application of CFC rules may pose an obstacle for international commerce and could reflect a severe negative impact and reduce the attractiveness of cross-border investment of the country that applies the CFC legislation. That is because the same income of the CFC could be subject to tax several times in the hand of different taxpayers. Therefore, countries with CFC rules are better off if they relief situations of CFC rules double taxation, where they preserve the attractiveness of their regimes and remove obstacle in front international trade and commerce. Moreover, Although, double taxation, in general, is first avoided by the enactment of unilateral domestic measures, however, they may not always be enough for the full elimination of double taxation. Therefore, countries tend to sign double tax treaties for the prevention of double taxation. The interaction of domestic and international rules is so far the best solution for the elimination of double taxation. However, tax treaties, as we have seen previously, are aimed the elimination of only economic double taxation and that is not the case in double taxations situations of CFC rules.

Hence, we are going to explore the possible solutions for the elimination of double taxation situations of CFC rules. That is including unilateral domestic measures and double tax treaties. Although, the benefit of tax treaties has been discussed before (Chapter IV 4.2), we will extend the discussion furthermore. Therefore, the discussion is divided based on national, regional and international aspects, dealing with relief measures and seeking to present all feasible solutions.

2.1 National Unilateral Solutions

When dealing with CFC rules, the assumption is that jurisdictions with CFC rules provide credit, or some sort of relief, for taxes paid by the CFC and include relief provisions for double taxation. This position is simply rational and logical considering that the jurisdiction in question is keen for both the prevention of base erosion and profit shifting and, in the same time, the protection of the attractiveness of cross-border investments. Therefore, a crucial policy consideration of CFC rules should be highlighted, which reflects on the objective of the country applying CFC rules. Where, CFC legislation is, in general, not aimed at raising the revenue of the jurisdiction with CFC rules. Instead it is aimed at tackling BEPS activities and preventing tax deferral (Chapter II 2). Likewise, that intention, mentioned previously, is shared by several countries with CFC legislation and also mentioned in the OECD's final report and the EU ATA directive.

Accordingly, countries with CFC legislation should provide effective relief measure for CFC rules double taxation. Therefore, implementing the recommendations of the final report is very necessary for a best practice level of CFC rules. Effective unilateral domestic measures are one of the best, and may be the only, solutions for striking a balance between tackling BEPS activities and protecting the attractiveness of foreign investments. Thus, CFC rules are expected to grant relief for taxes paid by the CFC, and that is already happening in several jurisdictions with CFC rules. However, it is more effective if countries limit the relief to the actual tax paid by the CFC, in order to limit opportunities of mitigating the rules. Moreover, Jurisdictions with CFC rules are either aimed at the prevention of the parent company base stripping or foreign-to-foreign base stripping. Nevertheless, CFC legislation should provide a credit for all taxes paid by the CFC, including those paid by an intermediary holding company. The existence of an intermediary holding company may pose the same CFC income to triple, or more, taxation, including the taxes paid by the CFC itself in the CFC jurisdiction and the taxes paid by the intermediary holding company under CFC rules. Therefore, CFC rules should grant relief for all taxes paid by the CFC and any intermediary CFCs. However, a hierarchy rule, like the one provided by the OECD in the final report, might be most appropriate.

Moreover, jurisdictions with no participation exemption rule are expected to exempt from tax, under their CFC legislation, the actual dividends distribution of the CFC income to the parent company having it taxed already under CFC rules. Jurisdictions may also relieve from tax, gains realised by the sale or dispositions of the CFC shares. The final report seems reluctant to assure on such exemption, where although it has been the advice of the OECD to exempt such gain from tax, they indicated that countries that do not wish to do so are fine and are not obliged to provide such exemption. It may be more appropriate to avoid double taxation and provide relief for such gains, a position that reflects the Nordic CFC regimes point of view.[284]

Furthermore, domestic relief provisions may also prevent or eliminate double taxation of CFC rules in other situations to the far possible extent. Situations such as the interaction between CFC rules and transfer pricing rules, this double taxation issue has been mentioned in the final report and jurisdiction with CFC rules are advised to relief such double taxation. One more situation of double taxation is also present when CFC rules subject the CFC income to tax at a time before the actual payment of taxes by the CFC in the CFC country. In this situation, jurisdictions with the CFC rules may allow a carry-forward

[284] Peter K. Schmidt, *Taxation of Controlled Foreign Companies in Context of the OECD/G20 Project on Base Erosion and Profit Shifting as well as the EU Proposal for the Anti-Tax Avoidance Directive – An Interim, (De Gruyter Open 2016) p. 101*

for the excess tax which is a result of the timing mismatches. Overall, jurisdictions with the purpose of tackling BEPS measures may design their CFC rules in the best way they see effective for the avoidance of double taxation.

2.1.1 Unilateral Measures and Tax Incentives:

The issue of tax incentives and CFC rules has been raised before and also it is mentioned in this work (Chapter III 3.2). Concerns were raised about the extent to whether a taxpayer under CFC rules should benefit from tax sparing provision of tax treaties. However, the question here is not related to tax treaties, instead, to the extent of unilateral domestic relief measures included of the jurisdiction applying CFC rules.

The issue is related to tax incentives provided to the CFC in the CFC country, which is a common case in several countries in the developing world. For instance, it is usual for African Portuguese-speaking-countries to provide tax incentives for Portuguese groups to attract investments, in addition to other countries which adopt the same scenario. The issue here is that the application of CFC rules will undermine the tax incentive provided by another country. Where, the tax incentive provided by the jurisdiction of the CFC for the CFC income will be ineffective, and the tax payable by the CFC in the CFC jurisdiction will be levied by the CFC parent shareholder jurisdiction under CFC rules. Although such concern may be discussed from the perspective of the tax sovereignty of the CFC jurisdiction,[285] still, jurisdictions with CFC rules will, without doubt, deny the previous argument and confirm the traditional view where it says that CFC rules taxes the resident shareholder of the CFC rules jurisdiction, and therefore no measures would restrict such taxation. Accordingly, the tax benefit of tax incentives is denied.

Nevertheless, the tax benefit "*consists in the introduction in the domestic law of rules that are motivated by non-tax reasons that lead to the denial of relief from taxation that would otherwise occur. The answer to the question of the relevance of the benefits envisaged in the tax law of the State where the entity is domiciled ... leads us once again to the previous essential question that underlines all this subject: the respect that a national legislator should grant to the legitimate tax decisions of a sovereign State. The existence of legitimate tax benefits should be recognized, motivated by acceptable reasons of social politics or economics.*"[286]

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[285] Rui Duarte Morais, *Imputação de Lucros de Sociedades não Residentes Sujeitas a um Regime Fiscal Privilegiado,* Publicação Universidade Católica, 2005

[286] Rui Duarte Morais, *Imputação de Lucros de Sociedades não Residentes Sujeitas a um Regime Fiscal Privilegiado,* Publicação Universidade Católica, 2005, (translated by reporters) in Cahiers, *The taxation of foreign passive income of group of companies,* Vol. 98 A (IFA 2013) p. 613

The concept embodied in the previous writing is quite important, the idea that CFC rules should be designed bearing in mind the tax sovereignty of the jurisdiction of the CFC. Such respect, although not mandatory, is in line with the rationale behind CFC rules. It is true that CFC rules tax the resident shareholder of the CFC on the CFC income and not the CFC itself, still, the rules are not aimed at raising the taxable base of the CFC rules jurisdiction. Moreover, the rules should have a deterrent effect on the behaviour of MNEs since most CFC rules are aimed at taxing only passive income of CFCs. On the other hand, CFC income that is subject to CFC rules is, in most cases, diverted and shifted either from the parent company base or from a third country taxable base. Hence, tax incentives provided by the CFC jurisdiction may work as a tool for the circumvention of CFC rules. Accordingly, CFC rules jurisdictions may argue that the source of income is not the CFC state and therefore, tax incentives should not be relevant for CFC relief provisions. Although tax incentives are a legitimate tool for countries to attract investments and to contribute to the development of the respected state, however, they may play an adverse effect and contribute to BEPS activities.

Despite all of what have been mentioned before in this section and as a counter argument for denying benefits for the tax incentives provided by the CFC country. The denial of relief for the tax payable on the CFC income having it derived from the CFC state and exempted from tax under a scheme of tax incentive provided by the CFC jurisdiction may seem unfair. Moreover, it is contrary to the rationale behind CFC rules such as those included in the final report of the OECD Action plan 3. Therefore, jurisdictions with CFC rules may be fairer if they provide a relief for tax payable by the CFC having its income derived from sources within the CFC jurisdiction. That position seems logical and rational, considering that the CFC state would reduce or temporarily eliminate its tax rate to certain business activities for the promotion of a fair goal. Underdeveloped countries would be at a competitive disadvantage if their tax incentives will be denied by countries that have CFC rules.

Notwithstanding the rationality of the previous position, concerns over the applicability of CFC rules relief of the CFC tax payable may arise. Again, the complexity of CFC rules could make it difficult for the realisation of such relief and two issues regarding the determination of the source of the CFC income should be taken into considerations. Frist, it might be hard to determine the source of the CFC income and this would increase the administrative burden and compliance cost. Second, CFC rules may be based on either the entity or transactional approach, and although, it might not be very hard in the transactional approach to determine the stream of income that is derived from sources within the CFC jurisdiction. However, that is not the case in the entity approach where all or no income is attributed to the parent shareholder company. Therefore, such relief if applicable may be more dependent on the taxpayer efforts to prove that the CFC income that benefits from tax incentives provided by the CFC country and is subject to tax under CFC rules of the parent jurisdiction is derived from sources within the CFC country. Hence, our opinion confirms that if the CFC income is derived from sources within the CFC jurisdiction and also benefiting form a tax incentive by the CFC jurisdiction, a relief should not be denied.

2.2 Regional Solutions:

The application of CFC rules would result, occasionally, in double tax situations having the CFC taxed in the jurisdiction where it is located. Double taxation of CFC rules is not something unexpected, in contrary it is a logical possible result of taxing a resident shareholder on the income on a non-resident foreign controlled company. Therefore, relief rules to prevent or eliminate double taxation should be considered when designing CFC legislation. The OECD in final report of Action plan 3 confirmed the importance of avoiding double taxation and embodied it in a separate building block (Chapter II 3.7). Effective unilateral domestic measures included in CFC rules are very sufficient for the purpose of double taxation relief. Moreover, the OECD final report recommendations are, to a certain extent, very effective for the elimination of most common double taxation situations generated by the application of CFC rules.

However, the issue of double taxation of CFC rules is dependent, as we said before, on the relief measures included in CFC rules in different jurisdictions. The main concern that may arise on the international level is that each states are sovereign and free to design their CFC legislation in the way they see appropriate. As jurisdictions, for example, are free to choose between the entity or transactional approach and between flow-through and deemed dividends approach, they are also free to include, or not, rules to prevent or eliminate double taxation of CFC rules.

Although, CFC legislation with effective relief provisions do strike a balance between tackling BEPS and preserving the attractiveness of cross-border investment, which in consequence will be better off for the jurisdictions applying CFC rules. That is not a guarantee that all countries will opt to include effective relief provisions in their CFC legislation. The OECD final report recommendations are a mere soft law which provides what is best practice of CFC rules and jurisdictions, therefore, are free to follow, or not, these recommendations.

Nonetheless, on the level of the EU things became different after the introduction of the EU ATA directive. As we have seen previously in this work (Chapter II 4), the European Union took the recommendations of the OECD in final report on Action Plan 3 and went further to embody the rules in a European directive. Hence, all Member States of the EU are obliged either to assure that their CFC legislation is in accordance with the EU ATA directive or to introduce CFC legislation to their tax system. The directive provides minimum standards for CFC legislation and indicates that member states are free to go beyond what the directive provides. Therefore, CFC rules of EU Member States are to a limited extent, if I may say, harmonised. Although not a full harmonisation, but the scope of the rules should always follow on of the options provided in the directive.

However, there are two main issues with the EU ATA directive. First, the directive is limited to EU Member States, thus although it is good on the regional aspect but internationally the issue still arises. Second, the EU ATA directive provides minimum standards for the rules of the elimination of double taxation of CFC rules, therefore, while several situations of double taxation are avoided but still, they do not eliminate all situations of double taxation of CFC rules. The EU ATA directive provide rules for the relief of three different situations (Chapter II 4.5) and seems to follow the same recommendations of the OECD Action Plan 3 stipulated in the final report. Member states are also required, by the ATA directive, to remove further obstacles of double taxation. The indication of the directive that in addition to the prevention of tax avoidance, the rules should not create obstacles to the market such as double taxation. Both, the OECD final report and the EU ATA directive shared the same opinion, however, the latter has the power to enforce it.

Accordingly, the most common CFC rules double taxation situations in the EU Member States may be avoided by the inclusion of relief provisions provided in the EU ATA directive. Moreover, the fact that the EU ATA directive is mandatory to be implemented would consequently mean the prevention and the elimination of double taxation situations mentioned in the directive. Nonetheless, other situations (such as those mentioned in Chapter III 3.1.4) may still arise which indicates that EU member states shall provide further relief rules. Member States, therefore, should take into consideration the relief of other situations of double taxation of CFC legislation.

2.3 International Solutions:

CFC legislation exists in several countries both inside and outside the European Union. Although, effective unilateral domestic relief measures are usually included in CFC legislation but still that is not always the case. Moreover, even though the EU ATA directive oblige the member states of the EU to implement certain relief measures, the scope of the directive is limited to the EU member states. However, if double taxation of CFC rules is elected to be solved by an international tool, it is then to the extent to whether relief provisions of tax treaties shall be applicable to double taxation situations of CFC rules. The compatibility of CFC rules with tax treaties is discussed already in Chapter III 4.2 and the opinion of the majority of jurisdictions with CFC rules, including the opinion of the OECD, is that tax treaties don't limit the application of CFC rules and therefore they are not affected by them. Hence, double taxation of CFC rules is seen by the majority of the jurisdictions with CFC rules to constitute economic double taxation and therefore it shall not be covered by tax treaties.

Although this position may be considered logical from a technical and traditional point of view, it may be considered to violate the spirit of tax treaties as explained before (Chapter III 4.1 and 4.2). Hence, we are going to briefly see the possibility of adopting a possible solution regarding double taxation of CFC rules and tax treaties benefits.

2.3.1 CFC Rules and Fiscally Transparent Entities:

The need to eliminate double taxation of CFC rules at the international level could be very important in the absence of effective unilateral relief measures. Although the position of a treaty benefits may seem to be negatively confirmed, there are still some arguments for extending treaty benefits to CFC rules. These arguments are based on treating CFCs as fiscally transparent entities,[287] and therefore they should benefit from tax treaties as fiscal transparent entities.

Considering that double taxation situations in fiscal transparent entities shall benefit from tax treaty provisions. The examination of CFC rules and fiscal transparent entities is quite complex and depend, in several parts, on the features of CFC legislation. CFC legislation with a flow-through approach would seem to be closer to the characterisation of fiscally transparent entities under the OECD MC.[288]

[287] See further detailed discussion on the topic; B. Kuzniacki, *The Need to Avoid Economic Double Taxation Triggered by CFC Rules Under Tax Treaties and the Way to Achieve It,* (Kluwer Law International 2015), Daniele Canè, *Controlled Foreign Corporation as Fiscally Transparent Entities. The Application of CFC Rules in Tax Treaties,* (World Tax Journal 2017), and D. Sanghavi, *BEPS Hybrid Entities Proposal a Slippery Slope, Especially for Developing Countries,* 85 Tax Notes Intl. (2017)

[288] OECD Model 2017 op. cit. commentary on Art. 1 para. 26.10

However, there are several arguments that support, or not, treating CFCs as fiscally transparent entities and are mainly based on CFC rules with piercing the corporate veil approach.

In short, arguments[289] in favour of treating CFCs as fiscally transparent entities include; (i), CFC rules taxation is similar to the partnership taxation. Where in partnerships, one states taxes the partnership and the other state taxes the partner, it is the same in CFC rules situation where one state taxes the CFC and the other state taxes the CFC shareholder. Therefore, CFC rules pose well-known issue already experienced with partnerships. (ii), According to BEPS project and last development of international tax law, coordination between domestic and international rules of tax law are needed for the objective of tax avoidance and therefore treating CFCs as fiscally transparent entities may support a consistent global application of CFC legislations in treaty situations. (iii), CFC rules that pierce the corporate veil of the CFC are similar to those in partnerships, where the treatment of the shareholder of the CFC is similar to the treatment of the partner in partnerships.

On the other hand, counterarguments also exist, and they are against treating CFCs as fiscally transparent entities for several reasons. One, (i) a political point of view would indicate that the residence state, according to fiscally transparent entities approach, may be giving up its taxing rights. That may occur whenever a CFC, which treated as a fiscally transparent entity, constitute a permanent establishment in the CFC jurisdiction and according the tax treaty signed between the CFC rules jurisdiction with the CFC jurisdiction, the residence state is obliged to exempt such income from tax under tax treaty law. (ii) the second argument is that CFC rules based on flow-through/piercing the corporate veil approach may be in conflict with tax treaties and, therefore, are not be compatible with the treaty provisions. (iii) the third one is that CFC rules are fundamentally different from pure transparency rules. Since, the computation of foreign-source income in CFC rules is contrary to partnerships. In partnerships, the resident partner is regarded as the person who received the foreign source income, CFC rules, on the contrary, regard the shareholder as the person to which the domestically sourced income is computed.

Nevertheless, in our opinion, adopting such solution may seem quite problematic and may still be not entirely efficient. Although there is a need for an international coordination for tackling BEPS practices, such position has its positive and its negative aspects. Moreover, in the context of our research for an international solution for the elimination of double taxation situation resulting of the application of

[289] The arguments mentioned in the paragraph summarise the work of Cané in Daniele Cané, *Controlled Foreign Corporation as Fiscally Transparent Entities. The Application of CFC Rules in Tax Treaties,* (World Tax Journal 2017)

CFC rules, treating CFCs as fiscally transparent entities, if adopted, will probably be limited to CFC rules that are based on flow-through/piercing the corporate veil approach. Therefore, regardless of the discussion whether CFCs are treated as fiscally transparent or not, and assuming the application of such rules, the limitation of the rules will expose another issue. Hence, double taxation situations of CFC rules may only be eliminated if the CFC legislation in question is based on the flow-throw approach.

Preventing and eliminating economic double taxation of CFC rules is indeed very important and it would otherwise, if not eliminated, affect international commerce. Moreover, relieving CFC rules double taxation under tax treaty provisions is one of the ideal solutions. However, it seems that reaching such solution is very hard, bearing in mind that most jurisdictions with CFC rules are reluctant to opt into such considerations. More importantly, even though such solution may face a lot of obstacle, it may not be the best solution to all CFC legislations. Therefore, it is very important to uphold further investigation for the impact of such solution on CFC rules with different features or structure. Thus, we have mentioned the option of treating CFCs as fiscally transparent entity as a possible solution to benefit from tax treaty relief provisions. Nevertheless, we see that currently it is very difficult to reach such solution since most countries with CFC legislation are taxing their own residents. Accordingly, they see that double taxation situation generated by the application of CFC rules constitutes economic double taxation and shall not benefit from tax treaties. Moreover, even if we apply this solution and treat CFCs as fiscally transparent entities, such treatment is limited to CFC legislation that are based on flow-throw/piercing the corporate veil approach. Accordingly, the solution will not be sufficient to eliminate all double taxation situations of CFC legislation. Therefore, we stand with the position that double taxation situations generated by the application of CFC legislation shall be dealt with in unilateral national measures. Since, we believe that an international solution is not available at the moment and may not be available any time soon.

3. Coping with the Consequences:

CFC legislation is aimed at taxing a non-resident foreign company's income in the hand of the resident shareholder. The rules are considered to be a fundamental piece of international tax rules. The rationale of the rules may differ from one jurisdiction to another, and also, they have been developing during the course of time. CFC legislations in general, especially following Action Plan 3 recommendations are a part of the anti-BEPS tools. The rules are aimed at tackling BEPS activities and at the protection of the national base of the jurisdiction which is applying the rules. CFC legislation, in general, is aimed at the passive or mobile income of a CFC that would be otherwise taxed in the hand of the parent shareholder. Furthermore, they are aimed at of taxing profits where the value is created and therefore should be subject to tax. Accordingly, CFC legislation does not tax all CFCs unless they meet certain criteria inclined in the legislation, and, therefore, they should play a deterrent effect on the behaviour of MNEs.

Moreover, the application of CFC legislation will indeed raise some issues and difficulties. Where the regime may target profits beyond those which are not intended by the legislation and therefore, they could target profits where the value is created. However, depending on the features of CFC legislation, several issues may arise, and solutions are always required. In this work, the focus is on double taxation of CFC rules and the efficiency of the relief provisions of CFC rules. Therefore, the need to eliminate double taxation of CFC rules is necessary whether it took place at the international or the national level. However, we have seen that, currently, double taxation of CFC rules is not, and hardly will be, relieved at the international level. Such double taxation constitutes economic double taxation which is generally outside the scope of double tax treaties.

Additionally, the OECD MC commentary is clear regarding its position of economic double taxation, it seems that the majority of OECD countries share the opinion that economic double taxation is not as harmful as juridical or legal double taxation and therefore, it has to be dealt with at the domestic level only. Although, economic double taxation of CFC rules is different from the one which result from classical corporate system. The position seems to be not changed by such differences, even though economic double taxation of CFC rules can seriously affect and reduce the attractiveness of foreign cross-border investments, where CFCs will be exposed to a higher tax liability. Therefore, jurisdictions with CFC rules are expected to include effective unilateral domestic measures for the prevention and the elimination of double taxation of CFC rules.

Considering the best relief scenario of double taxation of CFC rules, some situations would still be raised, and double taxation of CFC rules may be very hard to be entirely avoided. Moreover, bearing in mind that, in general, companies tend to choose their location where their production or services are supported with a good environment such as infrastructure, closeness to costumers, political stability or other factors.[290] CFCs that are subject to CFC rules, on the other hand, usually disregard the previous factors since they choose the location of their companies, primarily, based on tax avoidance factor. Therefore, CFCs that fail to meet the criteria which consequently have them avoid being taxed under CFC legislation should be aware of the risk that may be taking. The OECD in the commentary on Article 10 says: "*However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot fully be safeguarded by tax authorities*.".[291] Here, the commentary actually acknowledged the risk that taxpayers may be taking.

In other words, our opinion stands with the position that double taxation situations of CFC rules should be indeed eliminated, and that could be through unilateral domestic measures and relief provisions in the CFC legislation. However, CFC legislations, in general, are aimed at tackling BEPS activities, such as the recommendations provided in the OECD Action plan 3. Hence, CFCs that fall under CFC legislation which include efficient domestic measures for the relief of double taxation, and still face double taxation situation on the same CFC income should cope with the consequences of their decisions. Although, CFCs are not always established for the sole aim of avoiding tax rules, and therefore double taxation relief is generally provided. However, with the existence of effective relief measures of CFC rules, taxpayers should acknowledge the risk that they are willing to take.

[290] Grehard Kraft and Diana Beck, *Fifty Years of Subpart F Revisted in the Light of Modified Economic Conditions,* INTERTAX, Volume 40, Issue 12 (Kluwer Law International BV 2012) p. 685
[291] OECD Model 2017 op. cit. Commentary on Art. 10 note 39

4. Conclusions:

Multinational enterprises' practices of base erosion and profit shifting are indeed harmful to the jurisdictions' taxable base. Furthermore, the recent scandals proved that MNEs are paying too low, or no taxes in the jurisdictions where they are substantially operating. Therefore, jurisdictions felt the need to develop their anti-avoidance rules and/or introduce anti-BEPS measures. Although tax planning is legal and is in accordance with the letter of the law, aggressive tax planning schemes went far beyond the intention of the legislator. The OECD/G20 initiative on the project of BEPS Action Plans is playing a vital role in tackling harmful abusive tax practices.

CFC legislation is one of the essential international anti-BEPS tools for countering MNEs avoidance schemes. The rules exist, already, in several jurisdictions around the world. However, many jurisdictions are introducing CFC legislation to their tax regimes. Action plan 3 of the OECD BEPS project, provides best practice design for the development, or the introduction of CFC legislation. The final report of Action plan 3, provides jurisdictions with six building blocks for the best implementation of CFC legislation. Moreover, the final report contains several alternative criteria and thus, leave jurisdictions free to choose the design to which they believe appropriate for their policy considerations. Furthermore, the EU ATA directive lay down minimum standards for the introduction of CFC legislation in the EU Member States. The EU ATA directive seems to be following Action plan 3 recommendations, nevertheless, it still contains some differences. However, the transposition of CFC minimum standard rules provided by the EU ATA directive is mandatory for the EU Member States. A feature that is absent on the level of Action plan 3, where the final report is considered as soft law and only provide what is believed to be best practice.

The application of CFC legislation leads, on several occasions, to situations of double taxation. CFC legislation, in general, includes rules to prevent or eliminate situations of double taxation resulting from the application of the legislation. Moreover, Action plan 3, in building block six, provides three different solutions to three situations of double taxation of CFC rules. Furthermore, the EU ATA directive includes rules for the elimination of double taxation of CFC legislation. Additionally, both Action plan 3 and the EU ATA directive recommend jurisdictions to design their CFC legislation in a manner that avoids situations of double taxation.

Bearing in mind that Action plan 3 does not have a binding force and jurisdictions are free to implement, or not, the OECD recommendations. Additionally, the EU ATA directive is only binding to the EU Member States. Hence, situations of double taxation of CFC rules may reflect a significant adverse effect on both jurisdictions with CFC legislation and taxpayers located within these jurisdictions. Therefore, the OECD Action plan 3 explicitly confirms the vital importance of including rules to prevent or eliminate double taxation of CFC rules.

Accordingly, a jurisdiction with CFC legislation that includes relief measures of double taxation is, indeed, in a better position than jurisdiction with no relief measures. Nevertheless, relief measures that are provided in both Action plan 3 and the EU ATA directive may not be sufficient enough for the elimination of all situations of double taxation of CFC legislation. Although the rules provided may be effective for the elimination of the most common situations, several other double taxation situations of CFC rules remain not eliminated.

Furthermore, even though the interaction of domestic and international tax rules is considered to be the best tool for the elimination of double taxation. It seems that such interaction cannot benefit double taxation of CFC legislation. In fact, the complexity of CFC legislation and the economic double taxation character of CFC legislation double taxation, are a great obstacle in front of any tax treaty benefits. Adding on, the traditional opinion of the OECD and most of the jurisdictions with CFC legislation that the rules are considered to be compatible with tax treaties. Hence, tax treaties do not prevent the application of CFC legislation as a domestic anti-avoidance rules and, therefore, the application of such measures does not entail any benefit of tax treaties.

Accordingly, unilateral domestic rules are believed to be the best solution for the prevention or the elimination of double taxation of CFC rules. Jurisdictions with CFC legislation are better off including relief measures that deal with the situations mentioned in Action plan 3 and/or the EU ATA directive. However, jurisdictions with CFC legislation are also required to provide domestic relief measures for other situations that may arise by the application of CFC legislation. Additionally, jurisdictions with CFC legislation should provide credit for tax incentives provided to the CFC by the CFC jurisdiction if the CFC income is derived from the CFC jurisdiction. Otherwise, CFC legislation will, unfairly, undermine the tax incentives provided by the CFC jurisdiction and the tax benefit will be collected by the parent jurisdiction under CFC legislation.

Nevertheless, due to the complexity of tax rules, jurisdictions with sufficient domestic relief measures may not entirely eliminate all situations of CFC rules double taxation. Hence, taxpayers, in our opinion, should cope with the consequences that their BEPS schemes have led to, including double taxation situations of CFC legislation.

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